*ECONOMICS in our*

*DEMOCRACY*

# *ECONOMICS in our DEMOCRACY*


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*PREFACE*

*Economics in Our Democracy* is a textbook which portrays the American economic system within the framework of American democracy. It is the hope of the authors that this book will help young people to think earnestly and carefully about the many economic and social problems facing their nation. Basic economic principles are presented and analyzed in the light of present conditions and problems of the American system of democratic capitalism.

The subject matter of the book covers the major elements in American economic life. The wide range of business enterprise which produces, transports, and distributes the nation's goods is described in relation to the total structure of American life. The role of labor in our economy and recent trends in the organization and activities of labor receive extensive treatment. The place and problems of agriculture in the middle of the twentieth century are considered in relation to other elements of American life. The increasingly complex problems of the individual who consumes the goods and services of labor, business, and agriculture find an important place in this book. Moreover, personal economic problems relating to life insurance, union membership, home ownership, and taxation are given specific attention.

Classroom teachers will discover that the unit and lesson organization employed in this book makes it adaptable to a wide variety of teaching situations. On the basis of their long experience in teaching high school economics, the authors have attempted to select materials which are adapted to the needs and interests of high school students. Each lesson treats a single problem or subject, and there is logical sequence in the total presentation. However, the arrangement of the book is flexible enough to permit effective use in a variety of social-studies courses and classroom situations.

Special efforts have been made to produce a book which is a valuable instrument for the teacher. Economic terms and concepts have been realistically defined and developed. (Each term has been italicized the first time it is used in the book.) Exercises and activities which follow each lesson include vocabulary lists, factual summaries, thought-provoking questions, and suggested supplementary readings. Graphic materials have been integrated into the text and exercises, to provide frequent opportunities for development of social-studies skills. A special unit on "thinking about economic problems" has been placed near the beginning of the book. Graphic materials, quotations, and debatable points in the text have been carefully documented, in the hope that

such documentation will make students aware of the significance of primary sources.

Additional features of this book have been added to help young people understand the relationships between our economic system and some of our major social and international problems. Foreign economic systems with which our system must either compete or coöperate are discussed. Basic economic principles are applied in the consideration of international economic problems and the fundamental problems of achieving economic stability within a democratic framework.

A. H. S.
C. C.
S. N.

# *UNIT* 1

## ECONOMIC INSTITUTIONS AND SYSTEMS

*1* ECONOMIC ACTIVITIES AND INSTITUTIONS

*2* INSTITUTIONS OF CAPITALISM

*3* OTHER ECONOMIC SYSTEMS

# *LESSON* 1 ECONOMIC ACTIVITIES AND INSTITUTIONS

## The Meaning of Economic Activities

Economics may be a new school subject to you, but you have been participating in economic activities for many years. From the time you were born, you have been a *consumer,* that is, a user of *goods,* or articles, and services. You have eaten many kinds of food, worn clothing, and, together with your family, occupied a house or an apartment. You have used the services of laundry, barber shop or beauty parlor; of tailor, bus driver, plumber, electrician, and countless others. In your leisure time you may have enjoyed the use of a bicycle, athletic equipment, camera, workbench, radio, television set, and other goods. No doubt you have been to the movies many times; perhaps you have gone occasionally to ball games, the circus, or concerts; or have enjoyed other forms of recreation. In the summer you may have used the beaches, gone to camp, or stayed at a resort hotel. Even in going to school you have received the services of teachers, and have used goods like books, paper, and pencils. Every person participates in the economic activities which we call *consumption,* the using of goods and services to satisfy wants.

Now that you are approaching adulthood, you are nearing the time when you must start to earn your own living. That means that you must be able to secure, without complete reliance on your family, the means of acquiring the goods and services you want to consume. Some of you, in fact, may have already begun to earn money by part-time work.

There can be no goods and services for consumption until the goods and services are made available. This requires effort and skill; those who participate in the work of making goods and services are called *producers.* By participating in *production,* people acquire the money which is necessary to buy goods and services for consumption. Production refers to the operations by which plants, animals, and minerals are secured and turned into all kinds of goods available for our use. It includes the means by which goods get from the producers to the consumers—transportation, communication, banking, storage, and trade, or buying and selling. It includes also the services performed for us by such people as the tailor, garage mechanic, shoemaker, laundryman, lawyer, doctor, entertainer, delivery boy, and bus driver.

The kind of consuming and the kind of producing activity your family engages in depends in part upon the tastes, abilities, and training of the members of your family, and in part upon the community in which you live. The nature of the community—whether it is a farm area, a factory town, or a large city with a variety of factories, stores, and offices—will determine the kinds of work your family will do.

The economic activities of a community are not necessarily limited by its boundaries. The goods you consume, the supplies and material sold in stores, the raw materials processed in its factories, may come from neighboring places, or from other parts of the country. Many of the goods and services you use regularly are made possible by the work of people in other countries. Some of the goods produced in the community in which you live may be destined to be consumed by people living in the farthest corners of the earth. Thus, economic activities in the modern world are not local; they are national and international in their reach.

Your family's welfare is affected in many ways by the actions of government. The amount of spending which the family can do is affected by the amount of taxes which must be paid to the government. Some of the services your family uses are provided by the government; for example, schools and playgrounds. Laws may determine how much your family pays as rent and for electricity. Some actions of the government are related to the jobs you may hold and the money you may receive—for example, regulation of wages, the payment of pensions, or the encouragement or discouragement of sales of foreign-made goods in this country.

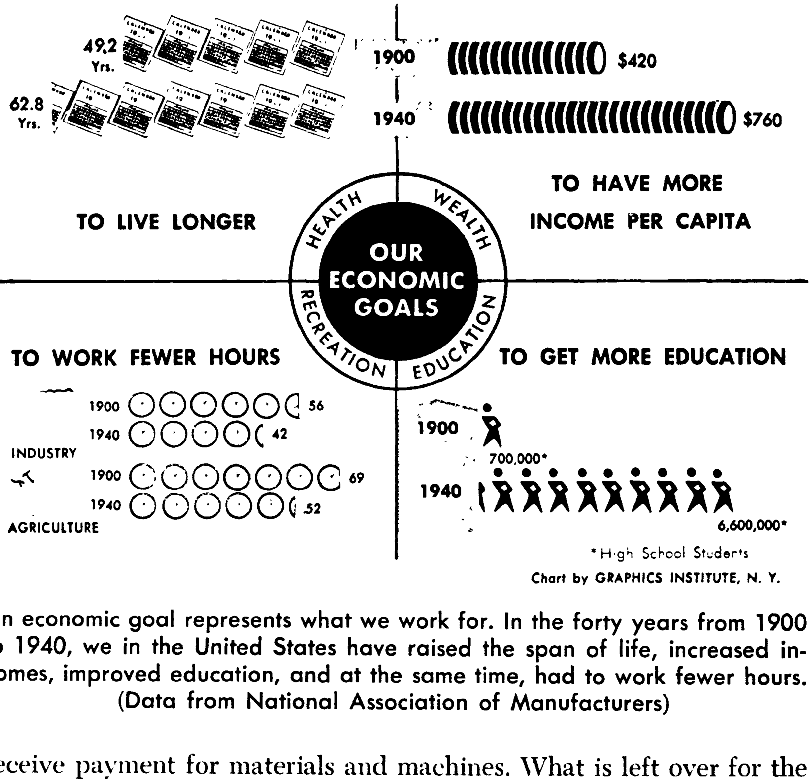
Thus economic activities are woven together in a complicated pattern involving individuals, groups, and governmental actions. The study of the pattern of production and consumption is the subject matter of *economics*. Economics may also be defined as the study of how people organize their activities for the purpose of making a living.

### Economic Value

Some goods are plentiful in nature and may be secured without effort; these are called *free goods*. Perhaps the best example is the air which we breathe. Most of the goods and services we need, however, exist in limited quantities and are not found in exactly the form in which they can be used. Effort and skill must be expended to secure them and make them useful. When such goods are brought into existence, people are willing to give something in return for them; these are called *economic goods* and have *economic value.*

People make their living by producing and selling goods which have economic value. For the most part, in this country, production activities

are organized by individuals or by groups of individuals. The producing and selling activity carried on by individuals and groups of individuals is referred to as business activity. A *business* is an enterprise formed to produce and sell goods or services. To buy goods and services, you must give the businessman money for them. He uses this money to pay those who assisted in the production and sale: workers receive wages, landlords receive rent, the government collects taxes, other businessmen




An economic goal represents what we work for. In the forty years from 1900 to 1940, we in the United States have raised the span of life, increased incomes, improved education, and at the same time, had to work fewer hours. (Data from National Association of Manufacturers)

receive payment for materials and machines. What is left over for the businessman is his payment or reward, called *profit*. The money spent by consumers keeps the entire world of business going.

### Income and Wealth

The allowance you may be receiving from your parents is your money income. Some of you may secure money income by doing part-time work. You may be thrifty and abstain from spending all your income on goods and services. In saving, you are accumulating *wealth*, which means the ownership of things which have economic value. Wealth may be in the form of goods—a house, an automobile, a factory, a fur coat, or anything which, because it can be sold, has economic

value. Wealth may be in the form of money or a bank deposit, because these are the means by which goods can be acquired at any time. Wealth may also be in the form of documents which are evidence of ownership. Your savings-bank pass book is evidence of your savings deposit; the government bond in your family's possession means that the government owes you a sum of money.

Wealth and income tend to go together. Having an income large enough to permit savings makes it possible to accumulate wealth; on the other hand, wealth can be used in business for the purpose of getting or increasing an income. Most people, however, secure their incomes by their work rather than through the ownership of wealth; they work for some business firm and receive an income in the form of a wage or salary. It is possible, moreover, to have wealth which produces no income. This is particularly true in bad times, when a business or real estate or investment may not produce any income. An individual may have wealth—a home or car, for example—which he uses himself and from which he does not attempt to earn an income.

The term "wealth" may cause confusion if we do not distinguish between individual wealth and social wealth. The individual's wealth may consist of goods or of money. He can use money to buy goods or to produce income, and for that reason it is wealth to him. It cannot be counted, in itself, as part of the wealth of the community. The same is true of *stocks* and *bonds* (see p. 175), and other evidences of wealth owned by an individual.

An illustration of this distinction between individual and social wealth is to be found in the experience of European countries whose wealth was destroyed by the war. The factories, mines, farm lands, homes, roads, bridges and other properties were ruined. Printing paper money in large quantities could not in itself give the people, as a group, more food, clothing, and homes, or replace the properties which had disappeared. Only as effort was expended, farms and factories restored, machinery provided, and new goods produced, could the wealth of these countries begin to grow once more.

## Economic Institutions

Economics has already been defined as the study of the activities related to earning a living. Another way of stating this would be to say that economics concerns itself with *economic institutions.*

An institution is an arrangement to which people have become so accustomed that changing it seems strange, difficult, and sometimes impossible. If someone were to ask why, in a baseball game, three strikes —not two or four—are out, we would probably be taken aback. We might answer, "Because that's the way the game is played. That's the

rule. It works fine. It wouldn't seem right any other way." Just as the rules of baseball are an institution of baseball, so we have political institutions, such as the right of individuals to run for office or to organize political parties. We also have social institutions pertaining to such matters as family life, education, and recreation. Similarly, we have become accustomed to many ways of producing and consuming goods that are customary in the community. These ways of producing and consuming are our economic institutions.

In this country we take for granted the right of every individual to decide for himself whether he will try to be a worker, businessman, or professional man; and in what field he will attempt to make his living. We have become accustomed to using ready-made goods, made in large factories by automatic machinery. We have become used to the fact that a large percentage of American workers belong to labor unions, and we recognize the right of workers to go on strike. In some parts of this country the outstanding economic institution is independent farming. The independent farmer operates his own farm with the help of his family. Department stores, neighborhood stores, banks, stock exchanges, sharecropping, foreign trade, taxes, and private ownership of homes—these are a few of the thousands of economic institutions which exist in the community.

Institutions are social habits which have developed gradually to their present form. This process of gradual change is called *evolution.* The long existence of an institution does not prove that it is either good or bad. However, the fact that people are accustomed to a given institution and feel that their well-being is related to its continuance will often make them resist sudden change. Slavery existed in the South for almost 250 years; the organization of the economic, political, and social life of the South was based on its existence. Its abolition made a violent difference in the life of the South and was therefore bitterly opposed. Sudden and drastic changes in basic institutions are termed *revolutions.* An example was the overthrow of the Czarist government in Russia in 1917, and the substitution of communistic institutions by the new government. Sometimes the term revolution refers to the completeness of the change, rather than to the speed with which the change takes place. When we speak of the industrial revolution beginning in the late 1700's and continuing to the present, we call the change revolutionary because the shift from hand tools to power-driven machinery altered thoroughly the nature of our economic activities.

A set of related political institutions constitutes a political system. Absolute monarchy under Louis XIV in France was one political system; democratic, representative government in the United States today is a

different one. A set of related economic institutions may be called an *economic system,* or an *economy.* Our country has a capitalistic system, and the Soviet Union has a communistic system.

The institutions in an economic system are closely intertwined. A change in one institution usually affects the operation of the others. When the industrial revolution began, it was a change from production of goods in the home, with hand tools, to production in factories using power machinery. With the passing of time, this change led to many other changes: population shifted to the cities, and housing problems became acute; women and children were employed in larger numbers, and family life took on a changed character; working conditions became very bad, and labor unions and government legislation were required to protect workers.

We live in a dynamic world, in which institutions are constantly changing. Your study of economics should help you to understand how our chief economic institutions operate, what problems have arisen in the course of their operation, and what are some of the solutions that have been presented to solve these problems.

## Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS: *In this and the following vocabulary exercises throughout the book, define each term and where possible give an example.*

| | | |
|---|---|---|
| business | economic value | institution |
| consumer | economics | producer |
| consumption | evolution | production |
| economic goods | free goods | profit |
| economic institution | goods | revolution |
| economic system | income | wealth |

II QUESTIONS AND PROBLEMS: *In these and the following questions and problems throughout the book, give your answers in well-organized sentences or paragraphs.*

1) "Economics is the study of production and consumption." "Economics is the study of organization for making a living." "Economics is the study of economic institutions." (a) Explain each of these statements. (b) Show how all three definitions are related.
2) Make a list of at least three reasons for studying economics.

3) How does the subject matter of economics differ from the subject matter of a business course?
4) Give some illustrations of the fact that economic institutions are continually changing.
5) (a) In what ways will a knowledge of history, geography, and government help you in studying economics? (b) Why are economics, history, and geography referred to as "social studies"?
6) George Soule has written a book entitled *The Useful Art of Economics* (Macmillan). Explain in what respects economics is a useful art.

III THINGS TO DO

1) From the daily newspaper clip items illustrating topics which can be discussed in your economics class. Organize a current-events section in the notebook that you keep for your course in economics.
2) Report to the class on the meaning of the term "institution." An advanced discussion of the term and of economic institutions may be found in the Encyclopedia of Social Sciences; in *The Trend of Economics* edited by Rexford G. Tugwell (Crofts); or in a dictionary of economics.

# *LESSON* 2 INSTITUTIONS OF CAPITALISM

## PRIVATE ENTERPRISE

Americans regard *private enterprise* as their basic economic institution. "Private enterprise" means that the production of goods and services is under the direction of individuals, or groups of individuals, who own the land, mines, factories, and other goods needed for production. These properties, which can be referred to as *capital*, are necessary if any production is to be carried on at all. Under a system of private enterprise they are owned and controlled by individuals who use them in business enterprises. Because of the central importance of capital in the production of goods and services, our system of private enterprise is described as a system of *private capitalism*, or as *capitalistic*.

The existence of private enterprise requires that the individual have certain legal rights. These rights would not be needed by the individual if all production were in the hands of the government. These legal rights, or *legal institutions*, are based upon a large body of law and legal customs which have evolved over many centuries, beginning in Europe, and taking root in America after being transplanted by the original settlers. Here, an extraordinary abundance of land and natural resources made it easy for private enterprise to flourish.

The concept of *private property,* which gives individuals and business firms the right to own, use, and dispose of property, is basic to the private enterprise, or capitalistic, system. *Property* is anything which can be used and has value. It consists of goods, such as land and buildings, machinery, steel, and wheat; or anything which represents ownership, such as money, stocks, and bonds.

The legal right to own, use, and dispose of property may be limited by the government if necessary for the general welfare. Many communities, for example, have zoning laws which state that, in certain areas, land and buildings may not be used for certain purposes. The limit on the power of government to curb private property rights has been set down in the Constitution. The fifth and fourteenth amendments to the federal Constitution forbid the federal and state governments to deprive any person of his property without "due process of law." Similar provisions are found in the constitutions of the forty-eight states. The government, however, has the right of *eminent domain;* that is, it has the right to force the sale to the government of property needed for public use, with the compensation fixed by the courts. It also has the right to seize and destroy impure foods and drugs without the payment of compensation to the owner.

A second legal institution is *freedom of contract*, which is the right of individuals and businesses to make agreements, or contracts, with each other for the use and disposal of goods and services. Refusal to fulfill the terms of a contract is a breach of contract; the courts will enforce the payment of damages, and in some cases require the fulfillment of the obligation. This principle is recognized in the federal Constitution, which forbids the states to pass any "law impairing the obligation of contracts" (Article 1, Section X, Paragraph 1).

Contracts are enforceable by the courts, provided they meet technical legal requirements and provided they are for a legitimate purpose. It is therefore possible to make business contracts with full confidence that if the contracts are in proper form, they will be carried out, and that damages caused by breach of contract will be paid.

The fact that individuals may own, use, and dispose of property as they see fit, together with the fact that agreements to use and dispose of goods and services will be enforced by the courts, gives every individual the power to choose his own way of making a living. He may buy any materials or equipment he is able to use; he may sell any goods or service he is able to produce with them. The prices which he pays and the prices he receives are determined by agreements with other individuals and are not usually controlled by the government. An individual may sell his services to anyone he pleases and may try to get the highest possible payment in return. This legal right of individuals

to choose their own ways of making a living is referred to as the right of *freedom of enterprise.*

Freedom of enterprise is limited where it is deemed necessary for public protection. For example, one may not engage in the practice of medicine or law without meeting state requirements and being licensed. A few businesses, such as railroad transportation and electric-power production, cannot be entered except by government permission, and


*Standard Oil Co. (N.J.), photo by Corsini*

Freedom of enterprise produces variety of enterprise. Note the many types of enterprise shown by the signs on one building—insurance, shoe repair, leather, law practice, dentistry, auto supply, telephone service, and in the distance a hotel.

the prices charged by these businesses are regulated by the government. During the war even the kind of job a person was permitted to hold was subject to regulation. However, freedom of enterprise is regarded as a basic institution, and limitations are imposed only where the need is clear.

### The Profit Motive and Competition

Individuals are willing to lend their efforts and skills to business enterprise, and to risk their properties, because they hope to gain some-

thing by doing so. The one who sells his efforts or skills as a worker receives a wage or salary. The owners of land and buildings receive rent for permitting their use. Lenders of money receive interest as a return. The businessman who makes use of the worker's labor, of the land, machines, materials, and other things necessary to production, must pay for their use. His aim is to sell the products of his business for more than it cost him. This difference is his profit, and is the incentive for his efforts. Each individual engaged in production efforts seeks to gain the largest possible income and to accumulate wealth. This incentive is referred to as the *profit motive*. It is the driving force behind the private enterprise system; it explains the willingness of individuals to undertake the responsibilities and risks in production.

In seeking increased income and wealth, individuals enter into rivalry with each other. Workers try to get the best-paying jobs; landlords try to obtain the highest rentals; businessmen try to sell as much as they can at prices that will yield the highest income. On the other hand, employers will try to get the best possible workers at the lowest possible costs; renters of property will seek to pay the lowest rentals possible; and buyers of goods and services will seek to obtain them at the lowest price. This rivalry for incomes and for goods and services is referred to as *competition*. So basic are profit seeking and competition that our economic system is often referred to as the *profits system* or the *competitive system*.

The quest for income and wealth is not the only force underlying human activity and ambition. There have been many examples of persons who have considered the pursuance of an ideal or a special interest more important than wealth. Love of country and one's fellow man must not be underestimated as driving forces behind human efforts. Yet, in the history of man, the quest for gain stands along with the search for adventure, the love of knowledge, and other motives, as an explanation of human progress. Columbus, Cortés, Hudson, and the other explorers and openers of the New World, were adventurous persons seeking new routes to wealth. The profit motive probably stimulated the genius of Watt, Whitney, Edison, and others. Samuel Slater brought the secrets of the new textile machinery to America because there were opportunities for profit making. Henry Ford made automobiles that could be sold cheaply—at a profit. One recent writer puts the case rather forcefully: "There is one way, and only one way, that any people in all history has ever risen from barbarism and poverty to affluence and culture; and that is by that concentrated and highly organized system of production and exchange which we call Capitalistic. . . . all this represents the aggressive drive of the deepest and strongest of human motivations: the will to live, to gain, to discover, to conquer.

. . . Deep is the prejudice against avarice, and thirst for gain. And yet they are literally the most beneficent forces in modern society."[1]

Critics of the institutions of profits and competition have been numerous. Some have charged competition, for reasons to be discussed in later lessons, with responsibility for waste of resources and inefficiency in production. Some have denied that the desire for material gain is a natural instinct of men and a necessary incentive to production. These critics have pointed to the unselfish work done by many kinds of people to support the argument that people could be educated to work for other reasons than individual gain.

### Individualism and Government Control

The private-enterprise system emphasizes the rights of individuals and is therefore referred to as a system of *economic individualism.* It is a basic principle of the capitalistic system that giving individuals the right to private property, freedom of contract, and freedom of enterprise will bring the greatest benefit to the community. This will result from the competitive activities of people seeking to enlarge their individual wealth and income. The most efficient businessmen, who have the best goods to offer for the lowest prices, will succeed in competition against less efficient businessmen. The best workers will receive the highest wages, because they too will be the most successful in the competition for the best jobs. Through competition it will be decided what prices will be paid, who will sell, and who will be unable to sell. The amount and quality of production will automatically be adjusted to meet the demands of consumers. The result will be that consumers will be able to acquire goods and services which are high in quality at low cost. There will be no need for the government to decide how much shall be produced, who should produce, and what the quality and price shall be. Government is required only to keep order, enforce contracts, guarantee property rights, and in general make it possible for business to function. This idea that the government should not interfere in business decisions and actions is expressed in the term *laissez-faire,* which means "let alone."

The man who first spread the idea that economic individualism and a laissez-faire policy by government would be socially beneficial was Adam Smith, often called the father of capitalistic economics. In his famous work, *The Wealth of Nations*, he summarized the argument of the economic individualist as follows: "It is his own advantage, indeed, and not that of society which he has in view. But the study of his own advantage naturally, or rather necessarily, leads him to prefer that em-

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[1] Carl Snyder, *Capitalism the Creator,* The Macmillan Company, 1941, pp. 3–13.

ployment which is most advantageous to the society. . . . He is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it."[2]

Individualism does not mean the complete absence of government control over the actions of individuals; that would be anarchy. We have seen in examples previously cited that the rights of private property, freedom of contract, freedom of enterprise, and the other institutions of capitalism have been limited. Government action to protect the health, safety, morals, or general welfare of the community is considered an exercise of the *police power* of the government. Changes in methods of production since 1776, when Adam Smith enunciated the idea of laissez-faire, have made necessary more and more applications of this power to transportation, banking, labor organization, methods of competition, and other aspects of the economy. Government regulation has become an established institution of capitalism as it functions in the United States today.

To some extent government engages in production enterprises, like power production in the Tennessee Valley. Such government enterprise is still minor, however, in comparison with private enterprise. Only where a necessity has been established, does the government exercise its power over individual enterprise, or establish its own enterprises.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | | |
|---|---|---|
| capitalism | freedom of contract | police power |
| competition | freedom of enterprise | private enterprise |
| economic individualism | laissez-faire | profit motive |
| eminent domain | legal institutions | property |
| | | private property |

II QUESTIONS AND PROBLEMS

1) (a) List and explain briefly the important legal and economic institutions of capitalism. (b) Why is our system often referred to as a system of economic individualism?
2) Show how private property and freedom of contract are necessary for freedom of enterprise.
3) There has been much controversy as to whether human progress depends upon the profit motive. (a) What benefits has the world derived from the profit motive? (b) What problems have been created

[2] Adam Smith, *The Wealth of Nations,* 1776, Book IV, Chapter 2.

by the profit motive? (c) What examples can you give of economic actions which are not spurred by the profit motive?

4) Explain the so-called "police" power of the government. Give some examples of the use of this power.
5) To what extent should government interfere with freedom of enterprise? Discuss. What arguments can you give for avoiding government restrictions on business? What arguments can you give for extending government restrictions on business?
6) Look through this textbook; list three problems which are discussed and which involve public regulation of private enterprise.

III Things To Do

1) Ask some of your relatives and friends whether they feel that there is just enough, too much, or too little, freedom of enterprise in this country. Write a summary of these opinions.
2) Read *How Can the American People Be Given a Better Understanding of Our Economic System?* distributed by *Time,* Inc., 9 Rockefeller Plaza, New York 20, New York.

# *LESSON* 3 OTHER ECONOMIC SYSTEMS

## Economic Institutions of Collectivism

Our economic system is one of economic individualism and private enterprise, based on private property, motivated by the search for profit, and controlled by competition. There is considerable government regulation, even some government ownership; nevertheless free, private enterprise is the predominant institution. Other systems make government enterprise the basic institution. *Economic collectivism* may be defined as an economic system in which the government, in the name of the people, owns and operates most of the nation's industries, and controls most of the economic activities of the people.

In a collective economy, the right of private property, which is basic in a private-enterprise system, does not exist or is thoroughly limited. Individuals may own personal property, such as clothing or furnishings; but capital, the means of production, is mainly government owned. Business is *socialized,* or *nationalized;* that is, business is owned and operated by the government.

It is within the power of the government in a collective system to permit private business to operate within limited spheres; for example, in farming, retail selling, or handicraft manufacture. However, the bulk of the important production of goods and services is in the hands of the government. Therefore the chance to make a profit can no longer be an

important spur to individual efforts. Both workers and managers are employees of the government. If a government enterprise makes a profit, the profit belongs to the government; it is socialized profit, not private profit.

The government fixes wages and qualifications for jobs. If it wishes, it may provide incentives and rewards for superior work by giving bonuses in pay. The government decides on the quantity and quality of goods to be produced, and fixes prices. If the people want more goods than the government factories have made, the government must either produce more, or reduce the ability to buy. If the ability to produce goods is limited, the government, by raising prices or reducing wages, can discourage buying. If production is very high, prices may be lowered, or wage rates may be increased. The important thing to note is that decisions regarding production, incomes, and consumption are made for all by the government's planning board or agency. Planning by government is a basic institution of a collective organization. In contrast, in the capitalistic system, planning is done by individual businessmen, each of whom aims at making a profit.

The impression, sometimes created by the use of the term "capitalism," that in other systems capital is not used, is obviously incorrect. No production can take place without capital. The distinction between capitalism and collectivism lies in the way in which capital is owned. "Capitalism" means private ownership of capital; "collectivism" means social ownership of capital. Hence the term *socialism* is often used to mean the same thing as "collectivism."

### The Importance of Political Institutions

A set of economic institutions can exist only where the political institutions make it possible for them to work. In our country the political institutions have been individualistic. The government is regarded as "the servant of the people," serving the interests of the individuals who make up the nation. Our political institutions may be described as those of *representative democracy*. This means that, through free elections, the people choose those who govern them. The government is required to respect, and is denied the right to abolish, certain fundamental rights of the individual. These rights to freedom of expression through speech and press, freedom of religious worship, freedom of assembly and organization, jury trial, and others are set forth in the federal and state constitutions and in the decisions of the courts.

Democratic institutions are the product of centuries of struggle. Many places in the world still do not know them. In some countries the attitude prevails that the individual exists mainly to serve the state in its efforts to reach some goal established by those in power.

Such a political principle has often been accompanied by complete authority of government over the individual, lest his personal aims run counter to the national aims. He has no rights except the ones granted by those in power. Every aspect of his existence—economic, political, and social—is regulated by law or custom which he dares not defy. Those in control of government, whether an individual, a family, or a single political party, must be regarded as solely competent to guide the people along the prescribed path. They control not only the law making and law enforcement, but also the schools, press, and all other means of education. The term *totalitarian* has been applied in recent years to such antidemocratic political philosophies and systems.

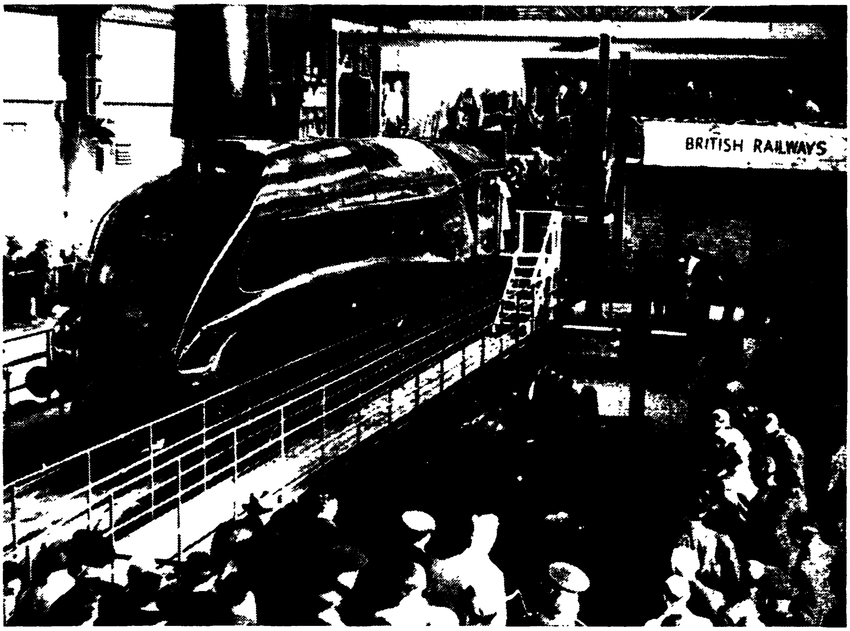
Opponents of collectivism argue that the political liberties of the individual cannot survive, once his economic freedom has been removed. In their opinion, collectivism, because of the vast economic powers of the government, must necessarily become totalitarian.

### Socialism

Socialists insist that democratic political institutions can thrive under collectivism. They vigorously deny the need for political dictatorship and force, either as a means of attaining collective ownership or as a device for government. In their opinion, the change from capitalism to collectivism can be made gradually and democratically by the majority of the people. As the problems of capitalism become more acute, the readiness to accept collectivist solutions will mount. Through political parties, other organizations, and literature, the socialists aim to bring public opinion to their way of thinking and to elect socialists to public offices. If they should succeed in getting majority control, their legislation would stress three things. First, it would provide for the nationalization of more and more key industries, with compensation paid to the former owners. Second, it would widen the regulatory, or police-power, functions of the government over private enterprise. Third, it would establish more and more government-sponsored insurance, pension, and other welfare schemes. Thus they hope to attain their program gradually through the existing framework of democratic and constitutional means.

There is a variety of opinion among socialists as to the extent to which private enterprise would be permitted to operate alongside state-owned enterprise. During the early stages of government ownership, a considerable amount of private business would continue to exist; ultimately all the chief industries would be socialized. But small-scale businesses in the fields of agriculture, retail selling, handicraft manufacture, certain professions, and newer luxury industries might remain in private hands.

Socialism should not be confused with public ownership and operation of specific business enterprises. In many countries today there are various mixtures of capitalistic and socialistic institutions. Railway, postal, telegraph, telephone, water, gas, electricity, and other such services have in many countries been furnished by public agencies; for example, in France, Australia, New Zealand, Canada, Great Britain, and the Scandinavian countries. In the United States, buses, subways,




*British Information Services*

In 1945 Britain moved in the direction of socialism when she *nationalized*, or placed under government operation and management, certain industries. Included were the railroads. Here the locomotive research center of British Railways is shown.

tunnels, bridges, and water systems are in numerous cases owned and operated by state and local governments. A country cannot be considered socialist, however, unless a major part of its economic system is in the hands of the government.

Because Great Britain was the cradle of our political and economic institutions, its postwar experiment in the direction of socialism has been followed with the keenest interest by American observers. Electric-power production and radio broadcasting had been nationalized in 1926. After the Labor Party won the election of 1945, it proceeded to nationalize the Bank of England, overseas airlines, coal mines, and rail-

roads. It also made plans for the nationalization of iron and steel production. A vast program of "cradle-to-grave" insurance was put into operation.

It is still too early to estimate the effects of the British socialization program upon the economic efficiency and the political institutions of Great Britain. Advocates have pointed to the gigantic problems created by postwar destruction of markets, rather than socialization, as the source of difficulty. Conservative critics, however, have blamed the socialistic program for inefficiency and rising costs. Communist critics, on the other hand, have assailed it as being an inadequate and halfway program of collectivism.

### Communism

Although socialists and communists both advocate economic collectivism, they are bitter political opponents. The reason is that present-day *communism* represents a program of totalitarian collectivism.

The communists argue that economic value can be produced by labor only. When the owner of capital makes a profit, he is taking what rightfully belongs to the working class, the *proletariat.* The aim of the proletariat, according to communists, should be to seize possession of the means of production, which are rightfully theirs. This will be accomplished through a revolution, organized and led by communist groups.

The communists seek to enlarge party membership and to elect representatives to the governments of capitalistic nations. But they do not place their reliance solely on gradual change through education and the ballot box. Their aim is to gain sufficient power to establish a dictatorship, through which the revolutionary change can be completed. This dictatorship must be controlled by the communists, even though they may be a minority of the population.

Because the communists regard their party as the only true representative of the working class, they term this dictatorship by the communist party as the *dictatorship of the proletariat.* The aim of the dictatorship is to eliminate the property-owning classes as enemies of the revolution and to establish a collective system. The communists claim, further, that after these changes have been completed and have been thoroughly accepted by the people at large, it will be safe to eliminate the dictatorship.

The dictatorship of the proletariat is undemocratic and totalitarian. There is the acceptance of the notion that a single group, even if a minority, must govern, because it alone understands the goals to be sought. Difference of opinion on matters that the ruling group considers essential is to be ruthlessly suppressed. Freedom of speech, press, religion, assembly, and organization is not a fundamental right

of the individual, because they may interfere with the attainment of the goals of the revolution.

A dictatorship of the proletariat was established in Russia as a result of the revolution of 1917. That country is now the Union of Soviet Socialist Republics. The means of production have been collectivized. Some private enterprise still exists in farming, retailing, and handicraft enterprises. But these cannot grow beyond family size, for in general, workers may be employed only in government enterprises. Trade unions and cultural associations are encouraged, but all are subject to thorough government control. A constitution has been adopted which sets forth the government's responsibility for employment and support in case of sickness and old age. The forms of representative government are provided for, but there is only one legal political party. Thus far there has been no evidence of any relaxation of dictatorship. National planning has been a notable feature. By means of "five-year plans" the government has undertaken to build up the means of production and a strong military force. Although it is difficult to get precise facts, the indications are that the Soviet Union has made much economic progress toward these aims. Standards of living, however, have been very low.

FASCISM

*Fascism* is a totalitarian economic and political system. Its supporters have no theoretical objection to private enterprise and private profit, provided these lend themselves to the advancement of national goals. Collective ownership of the means of production is not a basic institution, although state enterprise may be used where it serves the national purpose. Complete and thorough control of all individual and business activity by the state is, however, a fundamental characteristic of fascism. The government is the means by which a single legal political party dominates every action of the individual in the interests of goals set by the party and its leader. Italy under Mussolini, Germany under Hitler, and Spain under Franco have been examples.

Fascism proclaims that it is a means of combating the growth of communism. Fascists do not believe that a struggle between labor and the owners of capital is desirable; rather, the state should force coöperation between capital and labor, by rigid government regulation of labor unions and conditions of work. Democratic principles and individual rights are elements of weakness which must be eliminated.

Under fascism, the economic order is largely controlled by the government, but economic individualism can continue to exist. Profit-making opportunities may actually be increased for some people, because private enterprise is allowed, while trade unions are put under government control. Advocates of collectivism have labeled fascism as a

form of totalitarian capitalism. Actually the fascists have borrowed from the theory of both capitalism and collectivism in order to justify their aim of strengthening the power of the state.

Communism and fascism take root and flourish where there are hunger, dissatisfaction, and a lack of democratic means through which change can be effected. The task of an economic system is to provide the material means of existence. Its efficiency, however, must be tested not only by how well it serves that purpose, but also by how well it maintains personal liberty and individual dignity. How to secure the highest possible combination of personal liberty and economic security is a major problem of our century.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | |
|---|---|
| communism | proletariat |
| dictatorship of the proletariat | representative democracy |
| economic collectivism | socialism |
| fascism | totalitarian |
| nationalization | |

II QUESTIONS AND PROBLEMS

1) Compare a system of capitalism with a system of collectivism with respect to (a) private property, (b) freedom of contract, (c) freedom of enterprise, (d) government control and planning.
2) According to a pamphlet issued by *Time,* entitled *How Can the American People Be Given a Better Understanding of our Economic System?* an economic system must (a) force or persuade people to work, (b) determine what goods will be produced and in what quantities, (c) decide who shall produce what goods and what services, and (d) determine how the goods and services produced by the group will be distributed among its members. In parallel columns headed "Individualism" and "Collectivism," explain how each of the four tasks listed above is done in a capitalistic system and in a collective system.
3) Explain the difference between (a) private enterprise and collectivism, (b) socialism and communism, (c) communism and fascism.
4) The United States and Great Britain have both been outstanding examples of successful capitalism Yet Great Britain is now considered "socialistic." What differences have developed between the economic systems of the two countries in recent times?
5) One of the major questions of today is whether capitalism and communism can function peacefully together in the world as a whole. On the basis of current developments, what is your opinion?

## III Things To Do

1) Read *Socialism in Western Europe*, Headline Book No. 71, 1948, published by the Foreign Policy Association, 22 East 38th Street, New York, N.Y. This booklet summarizes the economic problems of the western European countries after World War II, and the effect of these problems on economic institutions.
2) Write a report on the British experiment with socialism, answering these questions: (a) Is the Labor Party still in power? (b) To what extent has the economic system been nationalized? (c) How successful has the government been in solving such problems as the cost of living, unemployment, social security, foreign trade? (d) Has individual liberty been preserved or lessened? For background material you may find useful *Britain's Road to Recovery*, Headline Series No. 74, Foreign Policy Association, 1949.
3) Write a report on developments in the communist-controlled areas of Europe and Asia. (a) How has the standard of living of the people been affected? (b) What is the status of individual liberty? Look for the latest materials of the Foreign Policy Association, such as Headline Book No. 77, *Eastern Europe Today*.

# UNIT 2

## ANALYZING ECONOMIC PROBLEMS


4 THINKING ABOUT ECONOMIC PROBLEMS

5 GETTING AND USING STATISTICS

6 STATISTICAL CHANGE AND INDEX NUMBERS

# *LESSON* 4 THINKING ABOUT ECONOMIC PROBLEMS

## SEPARATING FACT AND OPINION

The controversial nature of economic problems is reflected in the news items, editorials, and columns of newspapers and magazines, and in radio town meetings and other programs. Even professional economists, in their books and learned journals, are frequently engaged in controversy. Out of this crossfire of pro and con the citizen in a democracy must make up his mind and act.

In thinking about economic problems, the citizen's first task is to separate fact from opinion. As one writer has said, "The uneducated and the educated differ in nothing more than this, that the former believe whatever they hear or read, while the latter weigh evidence."[1] A fact is a proved or an observed truth. An opinion is what an individual or group thinks is an observed or proved truth. Opinions may be right or wrong. Until they are checked by observations which are accurately made, we cannot be sure that they are correct. If a correct count is made of the number of barrels of crude oil produced in the United States in a year, the number obtained is a fact. If a statement is made of the number of barrels of crude oil left underground, it is merely an opinion, or estimate, because no method has yet been found to make a precise measurement of the amount of oil underground.

We must guard against accepting as fact that which is only opinion. Opinions may have no factual backing, or they may be based on an incomplete set of facts. Sometimes because an opinion is printed in a book or made by an important person, we conclude that it must have a factual basis. We must guard also against accepting as fact those opinions which our own prejudices or intuitions make us want to believe. Propaganda, by repetition and clever use of words, by appeal to prejudice, may lead to wide acceptance of opinion as fact. Hitler's propaganda machine drove home the "fact" that the Germans were a master race. The constant repetition of this idea, and the distortion of science to "prove" it, did not make the idea a fact, but the Germans were led to act as if it were.

In recent years the opinion poll has become a popular technique for

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[1] Robert Livingston Schuyler, "Can History Educate?" *Columbia University Quarterly*, June, 1935, p. 101.

surveying public beliefs. A group of people supposed to be representative of the population is asked a series of questions usually requiring a "Yes," "No," or "Don't know" answer. Then the percentages answering in each way are computed, and are presented as reflecting public opinion. It must be remembered, however, that it is a poll of opinion, not of fact. Because a large percentage of people may believe that unions injure workers, or that big business is responsible for high prices, these beliefs are not necessarily facts. A poll of opinion in 1492 would no doubt have shown a widespread belief in a flat world; Columbus was nevertheless right. All that an opinion poll can tell is what people think is true. It does not necessarily tell what is true.

Newspaper editorials, the comments of the columnists, and letters to the editor represent primarily opinion. Sometimes there are more fury, denunciation, and calls to action than fact. The reader must ask, "What facts are given? Are they sufficient in number, importance, and general application? Are they related to the argument being made? Do they prove the point? Are there any important facts which have been overlooked?" The reader will find it profitable to read different papers with different points of view, in order to get a better understanding of the whole problem.

Sometimes the news columns of a newspaper, which are thought to be presenting only facts, really reflect opinion. In such a case, the newspaper is "editorializing" the news. It may be done in a variety of ways: by explanation or comment in the article, by a headline which is slanted, or by a lead paragraph which stresses some facts and not others. Very often a full reading of an article will give a different picture from that obtained by reading only the headline and the opening paragraph.

### Appealing to Authority

We cannot know all the facts in every field in which, as citizens, we are asked to pass judgment; we must rely heavily on the opinions of people who are authorities. Perhaps one good sign of the educated person is that he recognizes who the proper authorities are in various fields. When a name is presented as an authority we should ask, "Who is he, and what makes him an authority?"

It is important, too, to be sure that the person quoted is a genuine authority in the field under discussion. Mr. X, as an outstanding astronomer, may be a good witness in an argument about the position of the constellations, yet a very poor authority on foreign policy. Mr. Y may be a remarkable singer, actor, or playwright, and therefore an authority in his art, but he may not be the best available expert in matters like the causes of depressions, labor relations, or public housing. Mr. Z, who has had a successful career in manufacturing, may be incompetent

as a specialist on problems of agriculture. True, the opinions of an experienced man who has demonstrated a high order of ability in one field should be given serious consideration on any topic to which he has devoted time and study. But this man can usually not be considered as reliable an authority in other fields as he is in his own.

Sometimes an authority is misinterpreted or misquoted by the one who is citing him to prove a point. When a part of an article or speech is quoted in such a way as to give a false idea of the meaning conveyed by the entire article or speech, the person doing it is guilty of "quoting out of context." This is as unfair to the reader as it is to the authority cited. Sometimes reference to authority is made in a sweeping and vague way. A statement, offered as proof, to the effect that "all economists agree . . ." may be an opinion needing proof. It should be accepted only when made by an authority who is likely to know as a matter of fact that all economists do agree on the particular topic under discussion.

Finally, it must be said that even a good authority may be wrong, especially when predicting events to come. Depressions have arrived after expert predictions of continued prosperity; employment has remained high during periods when authorities had forecast widespread unemployment. Even the authority of the printed word and the signature of known and reputable specialists are not guarantees of correctness.

### Partial Truth and Overgeneralization

The witness in court swears to tell "the truth, the whole truth, and nothing but the truth." The repetition in the oath emphasizes the fact that a statement may be true as far as it goes, but omission of one or more facts may lead to false conclusions. Such a statement is a partial truth, and leads to jumping to conclusions from insufficient evidence. For example, the fact that the sales of the XYZ Corporation were twice as great in 1949 as in 1939 does not in itself prove that profits, too, were bigger in 1949. Omitted are the facts relating to selling prices and manufacturing costs which may alter the conclusion. Conclusions should be based on adequate and relevant facts.

Generalizing from just a few observations or personal experiences may produce an incorrect conclusion. The fact that you know a businessman who was not very smart, but who was very lucky, does not prove that business is all a matter of luck. Your knowing somebody who "sponged" on social security does not mean that social-security benefits make all workers lazy. The fact that you have had experiences with a racketeering union does not establish that all organized labor is an organized racket.

Overgeneralizations may also result from stretching a conclusion, correctly drawn from one situation, to cover situations not exactly the same. Suppose, for example, that experience showed that reducing the work week from 84 hours to 48 resulted in increasing the amount each worker could produce per hour. Could we generalize from this that, by reducing working hours to 30 per week, and then to 20 per week, we would continue to increase production per worker per hour? This may turn out to be an overgeneralization, unless we have enough evidence to justify such a conclusion. In economic thinking, as on the witness stand, we must seek to get "the truth, the whole truth, and nothing but the truth."

### Assuming the Facts

"If I pass all my subjects, I'll graduate in four years." An "if" statement is something we assume to be true to help our thinking, although we try to remember that it may not really be true at all. In economic thinking it is sometimes convenient, even necessary, to make such assumptions so that we can think our way through to a conclusion. Such an assumption upon which a conclusion is based is called a *premise*. Thus when an economist, knowing that population is always changing, assumes for a moment that there are no population changes, he does it to simplify the problem he has to solve. But he must not forget that this condition was an assumption and that his conclusion may be all wrong if applied to a situation where population does change. Therefore the reader must always watch for the writer's assumptions and be careful not to apply conclusions based on these assumptions to situations different from those assumed.

### Defining Terms

An author who has done much writing in the field of economics once said, "I recently asked a hundred persons from all walks of life to tell me what 'fascism' meant to them. The lack of agreement was fantastic. The indiscriminate use of abstract terms . . . . takes us clear out of the world of hard facts into a cloudcuckooland of fancy."[2] No doubt the results would be similar if other words used in economics, like "competition," "monopoly," "prosperity," and "inflation" were put to the same test. How often a heated argument ends with the confession, "Oh, if that's what you meant, there's no argument." Apparently one value of the discussion was that it forced, at its end, agreement on definition. How much more profitable the discussion would have been

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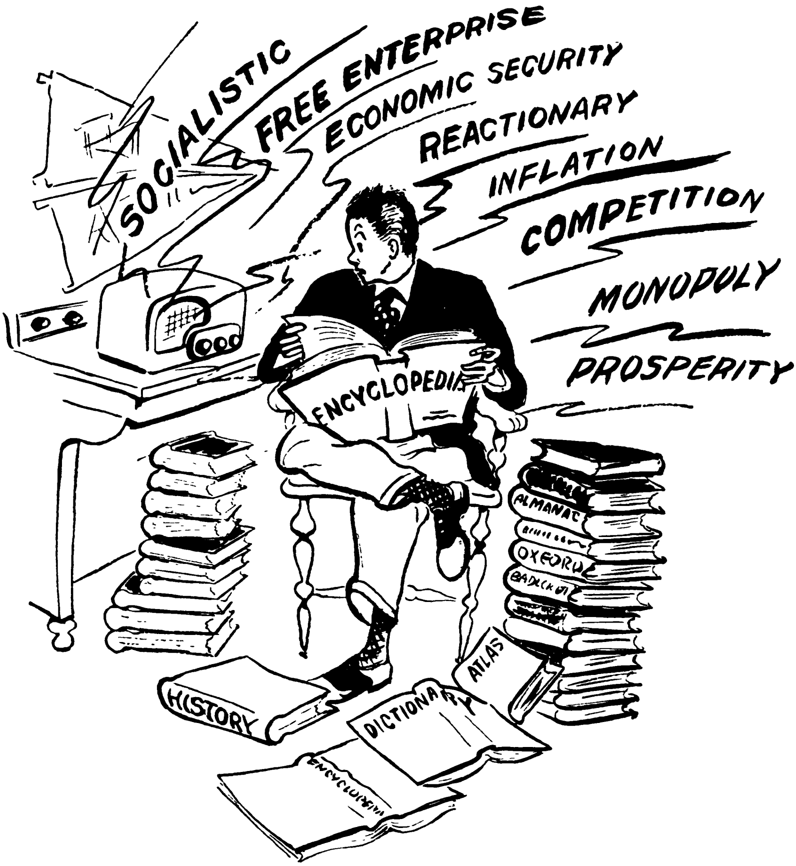
[2] Stuart Chase, "Word Trouble Among the Economists," *Harper's Mazagine,* December, 1937, p. 48.

if definition had been the first, instead of the last, step in the procedure!

Writers of works in economics frequently differ in their definitions because the terms they use are so broad that there is room within them for many meanings. The reader may therefore be familiar with several varieties of definition for the same term. He must be careful that he




Precise definitions make for clear thinking about economic problems.

does not carry one writer's definition into another writer's reasoning. He must examine every article or book he reads for that author's definitions, must understand them, and then must check to see whether the same definition is kept throughout. If, for example, capital is defined at the beginning as an amount of money used in production and, without warning or explanation, is used later to mean an amount of goods used in production, it may make a difference in the correctness of the reasoning.

### Comparison and Analogy

One of the most frequently used methods of explaining or proving something is to compare it with something else. If we know what a reservoir in a water system is, we can explain how banks operate by calling them "a reservoir of credit." Cartoons on economic or political subjects make frequent use of this device of comparison or argument by analogy.

Care must be exercised in using or accepting this kind of reasoning. Is a banking system like a reservoir? If only partly so, where does the resemblance end? Argument by analogy must not be misused by pressing it too far. We must take care to note the differences as well as the similarities, for the differences may sometimes be more important. The same caution must be kept in mind when historical comparisons or analogies are made. The points of difference between the periods after World War I and after World War II may be more meaningful than the points of likeness. Although we can learn much from previous experience, history never repeats itself in every detail.

### The Need for Decision

Economics is controversial. In a democratic country where the man in the street participates through his vote, the need for information and right thinking on economic questions is clear. Despite the difficulty involved in getting facts, in avoiding errors in interpretation, and in wading through the maze of embattled opinion, the citizen must make up his own mind. Failure to do so on the grounds that it is not possible to be sure about the correctness of the decision would result in paralysis of thought and action.

Democracy is no lazy way of life. The citizen who seeks to be informed must read widely and from varied points of view, so that he may get the whole picture. He must use critically the available material. He must participate as a citizen in making decisions even though he recognizes that these decisions are not final answers. When citizens fail to do their own thinking, dictators may arise to do it for them.

## Exercises and Activities

I Dictionary of Economic Terms

editorializing fact opinion premise
quoting out of context

II Questions and Problems

1) List and explain five types of errors in thinking which frequently occur in connection with economic problems.

2) What evidence is there in the headlines and columns of your daily newspaper that economics is a controversial subject? Bring in clippings to prove your statement.
3) Bring in an editorial, a letter to the editor, or some other newspaper clipping which is a mixture of fact and opinion. Underline the statements that are fact; place brackets around statements that are opinion. Be prepared to justify your analysis.
4) From a search of newspapers and magazines, bring as many examples of the following as you can find: (a) an appeal to authority, (b) a statistical fact, (c) an estimate, (d) the use of a term that is not clearly defined or not defined at all.
5) Cartoons dealing with public questions often make use of argument by analogy. Bring in a sample and explain what the analogy is.
6) Explain how the cartoon on page 42 uses analogy as a means of explanation.
7) Explain and give an example of (a) partial truth, (b) overgeneralization.

III THINGS TO DO

1) Compare two or more newspapers in your city as to the position and prominence given to different types of news—local, national, international, for example. Which newspaper provides more varied opinions in its columns, features, and editorials?
2) Ask ten people to define the following terms. Copy the definitions exactly. Bring them to class and compare. How many definitions are given for a single term? (a) inflation, (b) freedom, (c) competition, (d) socialism.
3) Pupils interested in language may be interested in reading further about the difficulties faced in using words to define meanings exactly. Look up references under the heading "semantics." *Language in Action* by S. I. Hayakawa (Harcourt, Brace, 1941), may interest advanced students. The first chapter gives an example which is economic in nature and very readable.

# LESSON 5 GETTING AND USING STATISTICS

## THE VALUE OF STATISTICS

Economics makes much use of *statistics*, the science of gathering and analyzing numerical facts. Most people use statistics in their daily lives without realizing it. Students, for example, are interested in examination averages. Baseball fans check the sports pages for the major-league standings, and compare the batting averages of their favorite players.

Radio newscasters may report that there has been a 1-percent fall in the cost of living.

Using statistics helps to make descriptions of events more complete and meaningful. It enables us to state definite amounts; to summarize a situation by giving totals and averages; and to compare different situations. Thus, instead of saying vaguely that there has been a rise of production, we can say that production for June was 135,347 units, as compared with 131,859 units in May. Also, the total production for the first six months of the year was 749,814 units, for a monthly average of 124,969; as compared with 702,468 units in the first six months of the previous year, for a monthly average of 117,078. Such comparisons enable a business firm to keep an accurate check on sales, costs, and many other important kinds of information. Similar gathering and analysis of statistical data enable the people of this country to watch economic developments.

The purpose of using statistical analysis is threefold. First, statistical data describe accurately what has happened, and what is happening. Second, the study of statistical data may help us to understand why things have happened as they did; that is, such study may help us to discover cause and effect. Third, this knowledge may enable us to anticipate what will happen, so that we can adjust ourselves to economic changes more easily, or even control these changes.

### The Reliability of Statistical Data

Statistics, properly gathered and presented, can be a valuable guide in making judgments. Improperly handled, they may be a means of giving an appearance of exactness to an untruth. Some errors in the use of statistics are made by the statistician; more are probably the result of improper interpretations by inexperienced or prejudiced users. Several points should be kept in mind in appraising the reliability of statistical data.

First, we cannot have accurate statistics about things which cannot be counted or measured. We can set forth data showing the number of crimes committed which have been detected, but we cannot expect to secure accurate data on the number of crimes which have not been detected, although we can, of course, have estimates as to their number.

Second, we must be sure that terms have been so defined that there is no confusion as to what is being counted or measured. If one count of the unemployed includes people who are too sick or too old to work, and another count excludes them, the two sets of data as to the number unemployed will differ and will not be comparable.

Third, we must distinguish between figures presenting facts and figures which are conclusions from facts. Suppose, for example, we are

told that a certain percentage of the entire population owned radio sets on a given date. That would probably be a conclusion from facts, since it would be too slow and too expensive to make a complete count of all the people in the country who owned radios. Instead, a sample group was chosen, containing some people from all areas, occupations, and income levels. These people were carefully questioned, and the number of radio owners counted. The result was a numerical fact, the percentage of this sample group who owned radios. From this fact was drawn the conclusion that in the entire population of this country, this particular percentage of people owned radios. This was a valid conclusion if the sample group accurately represented the entire population; that is, if there was a truly *representative sample.* If the sample group was not representative of the whole population, then the conclusion was misleading. Many years ago, when the editors of a magazine tried to predict who would win a presidential election, they polled telephone subscribers. They overlooked the fact that telephone subscribers were a relatively prosperous group and did not give a representative sample of the entire population.

Fourth, we must recognize that collecting data by asking people questions may not yield correct facts. People may not understand the questions clearly, may answer without adequate knowledge, or may not give an honest answer. Suppose the question is, "How much does your family spend on recreation?" The results may be unreliable because of different interpretations of what constitutes recreation. Moreover, some of the individuals questioned may not know the facts with any degree of accuracy. Sometimes they may give the answer which they think the questioner wants, or which will reflect prestige on themselves.

Fifth, we must be sure of the honesty, integrity, and impartiality of the individual, firm, or group gathering and presenting the data. Groups who want to shape people's opinions may select only the data which suit their purposes. Those statistics are best which have behind them the authority of generally recognized sources of statistical data.

### Sources of Statistical Data

Knowledge about the reliability of different sources comes from use and experience. Most of our statistical data dealing with economic questions originate with some government agency. *The Survey of Current Business,* the *Federal Reserve Bulletin,* and the *Monthly Labor Review* are examples of regular monthly publications which give up-to-date statistics compiled by government departments. Special studies by government departments and congressional investigations have also yielded mountains of economic fact. A letter to the Superintendent of Documents, Government Printing Office, Washington 25, D.C., will

bring information about the many statistical reports issued by agencies of the federal government. Many states and municipalities also make available statistical summaries of their major activities.

There are statistical services which, for a fee, provide information to industry. Examples include Standard and Poor's Corporation, which specializes in investment and financial statistics; Dun and Bradstreet, Inc., which is best known for its credit ratings and information on business failures; and the Research Institute of America, which presents statistical reports, although it stresses legal interpretations. Private research organizations supported by membership subscriptions, or bequests and endowments, are among the best sources of statistical data. The National Industrial Conference Board, the National Bureau of Economic Research, the Brookings Institution, and the Twentieth Century Fund are examples of such organizations. Large corporations, chambers of commerce, and labor unions all have their own educational and research departments to collect and analyze data. A tremendous amount of statistical work is also done in colleges and universities.

The data gathered by these organizations are found in huge files and fill many volumes. Selections of the most useful and significant statistics are published annually in one-volume form, classified and indexed for ready reference. These books are secondary references. One valuable example is the *Statistical Abstract of the United States*, published each year by the federal government. Government departments issue summaries in their annual reports or in the form of yearbooks. The Department of Agriculture publishes an *Agricultural Yearbook*, and the Bureau of Mines a *Minerals Yearbook*. Best known to the average person are the almanacs published privately each year, which give a wealth of information in many fields; examples are the *World Almanac, Information Please Almanac*, and the *Economic Almanac* of the National Industrial Conference Board. Data presented in magazine articles may be discovered by referring to the *Readers' Guide to Periodical Literature. The New York Times*, which presents many reports of all kinds in their full text, publishes a complete index to all its articles. Many libraries have these reference materials.

### Presenting Statistical Data

The aim in presenting statistical data should be to make them as easy as possible to understand. One way is to present the actual numbers in a logically organized arrangement with vertical columns and horizontal lines. This is presentation in a *statistical table*, or in tabular form. The table should bear a complete title explaining the nature of the data and giving the dates to which the figures apply. Explanations at the left, or stub, of the table and at the heads of the columns should also appear.

It is good practice to state the source of the data, either in the title or in a footnote.

Suppose, for example, that the head of a department was asked for a statistical description of weekly salaries and payrolls. The tabular presentation might appear as follows:

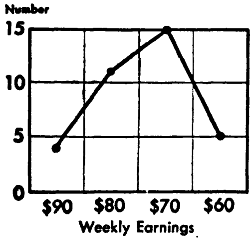
DISTRIBUTION OF WEEKLY SALARIES AND PAYROLL IN THE DRAFTING DEPARTMENT OF THE ABC ENGINEERING CORPORATION, APRIL 1949

| a | b | c | d | e | f | g |
|---|---|---|---|---|---|---|
| *Weekly Salary* | *Number of Employees* | *Percent of Employees* | *Cumulative Percent* | *Payroll by Group* | *Percent of Payroll* | *Cumulative Percent* |
| $90 | 4 | 11.4 | 11.4 | $ 360 | 13.9 | 13.9 |
| $80 | 11 | 31.4 | 42.8 | 880 | 34.0 | 47.9 |
| $70 | 15 | 42.9 | 85.7 | 1050 | 40.5 | 88.4 |
| $60 | 5 | 14.3 | 100.0 | 300 | 11.6 | 100.0 |
| *Totals* | 35 | 100.0 | —— | $2590 | 100.0 | —— |

The term *distribution* in the title tells us that the table shows how many of the group received each salary. It will be observed that this is shown in two ways: by number of employees and amount of payroll, and by percentage of employees and percentage of payroll. (Compare columns b and c, and columns e and f.) Two columns, d and g, are headed "cumulative percent." A *cumulative percentage* tells the percentage falling above or below a certain level. Thus, as shown in column d, 85.7 percent of the men received a weekly salary of $70 or higher, while 42.8 percent received $80 per week or higher. Column g shows the cumulative percentages for payrolls: 47.9 percent of the payroll went to pay those receiving $80 per week or higher, and 13.9 percent was paid to those receiving $90 per week or higher. The cumulative percentages could also have been figured to show the total percentage of those receiving less than a given salary.

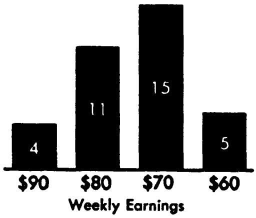
A second way of presenting statistical data is through the use of *graphs*. Graphic presentation shows numerical relationships by means of lines, bars, circles, and other pictorial or visual forms. The type of graph used will depend upon the aim in mind. The advantage of a graph over a table is that it makes clear to the eye, quickly and without the need for mental arithmetic, what the numbers say. On the following pages the possibility of varied methods of graphic presentation is demonstrated by showing seven ways of representing the data in this table. These seven graphs or charts are all made from the simple data presented in the lesson. The type of graph used depends on the purpose in mind and on the skill of the reader for whom it is intended.

**DISTRIBUTION OF WAGES BY NUMBERS OF WORKERS**




(1)

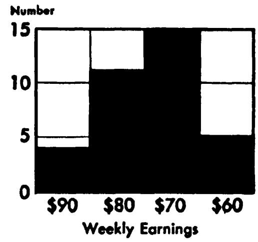
**NUMBER OF WORKERS IN FOUR SALARY GROUPS**




(2)

**DISTRIBUTION OF EARNINGS**

35 cases



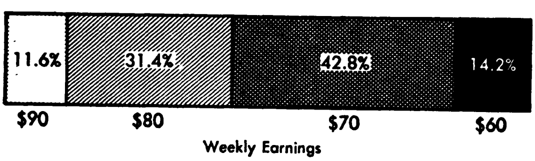

(3)

**(1)** *Line Graph.* This is the most common form of graph. The bottom scale is the horizontal scale or horizontal axis; the side scale is the vertical scale or vertical axis. The number of workers is shown on the vertical scale, and the salary level is shown on the horizontal scale. Using the figures from the table on page 35, the points, corresponding to the numbers of workers, are plotted in the centers of the spaces of the horizontal scale.

**(2)** *Bar Chart.* This is a vertical bar chart. The values are printed on the bars, eliminating the need for a scale at the left. The chart may also be drawn with horizontal bars, which would be more convenient if the description of each bar required several words rather than a number.

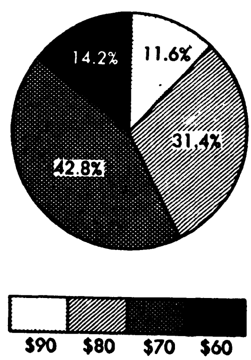
**(3)** *Histogram.* In a line graph, plotted points are connected with a line, but in a histogram a horizontal line is drawn through each point and then all are connected in a series of steps. This prevents drawing wrong conclusions regarding values between plotted points. In this chart the space under the line has been filled in. This makes a more attractive graph and at the same time directs attention to the important part.

**PERCENT DISTRIBUTION OF WEEKLY EARNINGS AMONG 35 WORKERS**




(4)

**PERCENT DISTRIBUTION OF 35 SALARIES**

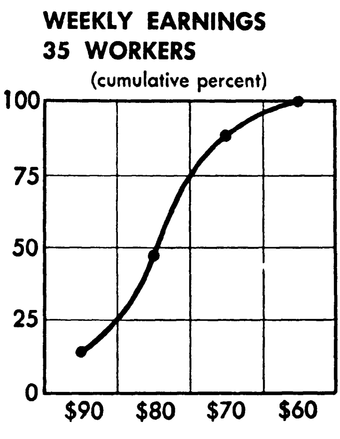



(5)

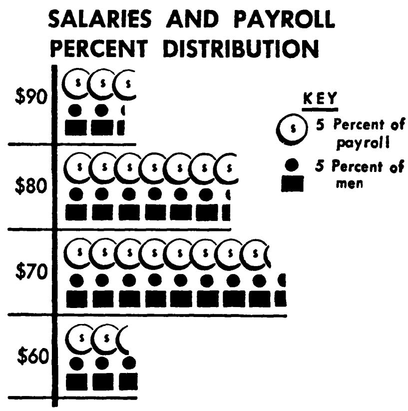
**(4)** *100% Bar.* Here the aim is not to show amounts but to show percentages of the total. The length of the bar is fitted to whatever space is available;

the important feature is the percent division of the bar. Often, to make comparisons between different groups, places, or dates, several 100% bars are placed next to each other. Although the totals for each set of data may differ, all the bars will be of the same length because each is equal to 100%. To make comparison easier, dotted connecting lines may show how the percents, or *component parts,* vary.

**(5)** *Pie Chart.* Here a circle is used instead of a bar. Otherwise the graph is the same as the 100% bar and is used for the same purpose. The size of the circle is unimportant; as in the 100% bar, the proportion of its parts is the significant point. The disadvantages of the pie chart compared to the 100% bar are twofold: side-by-side comparison is not so easy, and it is harder to show values because a scale going around a circle is fairly difficult to read. This graph illustrates also the use of a key (given beneath the circle) to show the meaning of shadings.




(6)




(7)

**(6)** *Cumulative Percent Chart.* This type of graph is rarely used. The vertical scale shows the percent receiving *more than* the salary level stated on the horizontal scale. For example, to find what percent of the workers received more than $70 per week, it is necessary to find where the point plotted in the center of the $70 space falls on the vertical axis. Examination shows this to be between 75% and 100%, at approximately 85%. Therefore, about 85% of the men received *more than* $70 per week. If each of the four salary groups had 25% of the men, that is, if the distribution had been equal, the line would have been a straight one.

**(7)** *Pictorial Chart.* This is like a bar chart except that symbols have been used to make the graph more attractive and to present the idea more clearly. The symbols should be appropriate to the thing being counted. Each symbol stands for a stated percent of men or of payroll. This graph also differs from the others in that it compares two sets of related data in one graph. The same thing can be done with lines, bars, or circles.

Note their variety. Though no source has been quoted in this instance, it is good practice to show the source of the data in the title or in a footnote. Notice also the different ways in which the title may be set forth.

### Using Averages

The table of weekly wages on page 35 is really a kind of numerical description of the wages of a group of individuals. It sets forth the distribution of wages by telling how many workers received each wage. Another way to give a numerical description of the group is to state the *average* wage.

There are different kinds of averages, and the statistician knows that it is important to use the right one for his particular purpose. The most common kind of average is the *arithmetic mean,* which tells how much each member of a group would get if distribution were exactly even. Here is the way it is computed:

| *Weekly Salary* | × | *Number of Employees* | = | *Payroll* |
|---|---|---|---|---|
| $90 | × | 4 | = | $360 |
| 80 | × | 11 | = | 880 |
| 70 | × | 15 | = | 1050 |
| 60 | × | 5 | = | 300 |
| | | 35 | | $2590 |

$$\frac{\$2590}{35} = \$74 = \text{arithmetic mean}$$

In this case, if all employees had received the same amount, that amount would have been $74. No employee actually received the average amount. The arithmetic mean does not describe any individual in the group, except by coincidence; it gives a single number which can be used to describe the group as a whole. This average is valuable for comparing one group with another. It may be important for the ABC firm to know that the average wage of $74 in its drafting department is $6 lower than the average wage in the drafting department of its competitor.

Another kind of average used frequently in statistical work, but much less familiar, is the *median.* The median is the number which is exactly in the middle when the numbers of a group are arranged in order of size. The first step in finding the median is to arrange the items in order of size. Such an arrangement for the same figures we have just used might appear as on the next page.

The middle wage, whether counted from the first downward or from the last upward, is the 18th one, which is $70 per week. This is the

| *Rank* | *Amount* | *Rank* | *Amount* | *Rank* | *Amount* |
|---|---|---|---|---|---|
| 1st | $90 | 13th | $80 | 24th | $70 |
| 2nd | $90 | 14th | $80 | 25th | $70 |
| 3rd | $90 | 15th | $80 | 26th | $70 |
| 4th | $90 | 16th | $70 | 27th | $70 |
| 5th | $80 | 17th | $70 | 28th | $70 |
| 6th | $80 | 18th | $70 | 29th | $70 |
| 7th | $80 | | | 30th | $70 |
| 8th | $80 | 19th | $70 | 31st | $60 |
| 9th | $80 | 20th | $70 | 32nd | $60 |
| 10th | $80 | 21st | $70 | 33rd | $60 |
| 11th | $80 | 22nd | $70 | 34th | $60 |
| 12th | $80 | 23rd | $70 | 35th | $60 |

median wage. This type of average is sometimes preferred to the arithmetic mean because it is not influenced by a few very high amounts or a few very low amounts. In the above example, if the four receiving $90 per week were to be raised to $150 per week, the arithmetic mean would change to over $80; the median, however, would still be $70.

The most important thing for the user of averages to remember is that whatever the type of average used, it describes a whole group of numerical facts rather than any single one. There is value in comparing individuals with the average, but the average itself tells nothing about an individual. The average wage may be $74 or $70, depending upon the kind of average used; yet some may be receiving $90 and others only $60. The average mark for an entire class of pupils may be 72 percent; yet some may fail and others get perfect marks. An average describes the group, not necessarily any individual part of the group.

An average may be computed in such a way as to give more weight to some of the numbers being averaged. Such an average is called a *weighted average*. Students are acquainted with weighted averages even though the term may be strange. If the class work is counted twice as much as test marks, or the mid-term test is counted as equal to three ordinary tests, it means that certain marks are being given more weight than others. The final mark is then a weighted average. In figuring the average price paid by a family for all the things it buys, the economic statistician may give each item a weight depending on how important it is in the family budget. This would be a weighted average. The method of weighting used may make a great difference in the size of the average.

In general, then, the methods used in computing averages, the skill of the statistician, his honesty of purpose, and the accuracy of his work, are all important in determining the reliability of the averages. Finally, the value of statistical data depends not only on the skill and honesty

with which they are gathered, selected, and presented, but upon the intelligence and understanding with which they are interpreted.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | |
|---|---|
| arithmetic mean | median |
| cumulative percentage | representative sample |
| graph | statistics |
| weighted average | |

II QUESTIONS AND PROBLEMS

1) (a) What is meant by "statistics"? (b) Show how statistics are valuable in the study of economics. (c) List three sources of statistical data.
2) "A statistical sample should be a cross section of the group as a whole." (a) Explain the above statement. (b) How would you go about selecting a representative sample of the student population in your school for purposes of a survey?
3) In 1935–1936 the median family income was $1,285. (a) Explain the above statement. (b) Write one conclusion it would be wrong to draw from this statement.
4) What is meant when a person is referred to as "average"? Criticize such a statement from the point of view of the statistician.
5) A survey of prices for a certain article on the same day in 21 different stores showed the following:

| | | | | | |
|---|---|---|---|---|---|
| 3 | stores | sold | it | for | $3.00 |
| 2 | " | " | " | " | 4.00 |
| 4 | " | " | " | " | 4.50 |
| 6 | " | " | " | " | 5.50 |
| 5 | " | " | " | " | 6.00 |
| 1 | " | " | " | " | 7.00 |

Determine the average selling price of the article by finding (a) the arithmetic mean, (b) the median.

6) Look through this book. List the page numbers on which you find examples of each of the different types of graphs shown on pages 36–7.
7) Bring in a graph from a newspaper or magazine. What kind of graph is it? Explain how it makes interpretation easier than tables or numbers would.
8) A questionnaire prepared by a magazine had to be abandoned because it proved that its readers alone owned more Rolls Royce cars than had ever been produced. How does this example illustrate the difficulties and dangers in gathering data by the use of the questionnaire?

9) In baseball we hear of team averages, batting averages, fielding averages, pitching averages. (a) Explain how such averages are figured. (b) How does this use of the term "average" differ from its more common use as explained in this lesson?

III Things To Do

1) Visit your school library and your nearest branch library outside school. Which of the references mentioned in the lesson does each have on hand?
2) Footnotes are used to state sources of statistical data. By consulting the footnotes in this book, state the names of (a) a study made by a government agency, (b) a study made by a private organization.
3) Prepare a report on the kind of information you find in one of the following: (a) *Monthly Labor Review*, (b) *Survey of Current Business*, (c) *World Almanac*, (d) *Statistical Abstract of the United States*, (e) *Federal Reserve Bulletin*.
4) Consult *U. S. A.: Measure of a Nation* by Carskadon and Modley (Twentieth Century Fund, 1949) for many excellent examples of varied graphics on important economic issues. Copy one or more for class display.

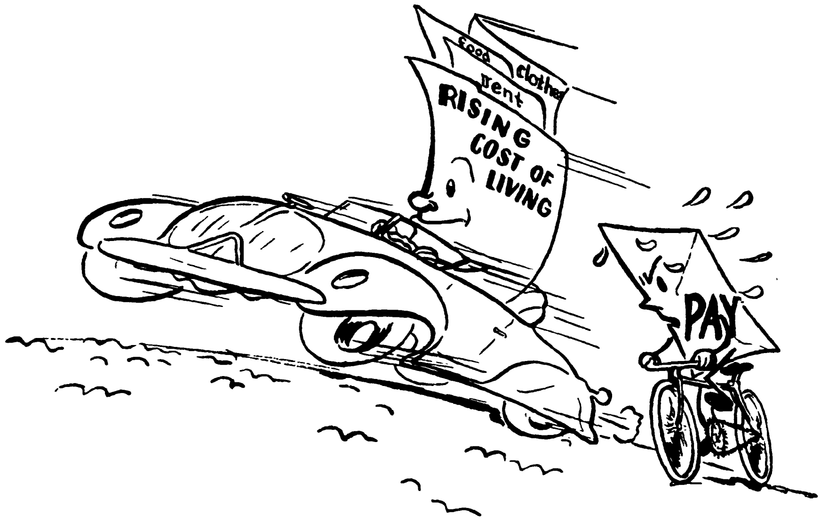
# *LESSON* 6 STATISTICAL CHANGE AND INDEX NUMBERS

## Absolute and Relative Change

The subject matter of economics is concerned with factors whose value rarely remains the same; prices, wages, incomes, profits, and costs are constantly changing. The economist is as fully interested in how much they are changing as he is in how large or small they are at any particular time. Furthermore, he is interested in knowing how the change in one item compares with changes in others. The cartoon on the next page pictures a race between cost of living and wages. Such a race—typical of the relationships between economic factors—is never over, and there is no final winner; the economic effects at any given time depend upon which factor is moving faster.

In economics we are constantly concerned with measuring, stating, and comparing the degree of change taking place. Change can be set forth in two ways, as an *absolute change* or as a *relative change.*

An absolute change expresses the amount of change in an item at different times. The table on the next page shows the absolute change in costs per pound in the price of meat from 1939 to 1947.




Economic conditions are affected by relative changes in economic factors.

It will be noted that the direction of change, up or down, is shown by a plus or minus sign before the amount. It will be observed, too, that the third column shows the change compared with the preceding year, the fourth column shows each change compared with 1939. Thus it will be noted that the price declined by 2.5 cents from 1943 to 1944, but was still 5.4 cents higher than in 1939. These are simply two different ways of stating an absolute change in the price.

Amount of Change in Average Retail Price of Round Steak in U.S. Cities, 1939–47

| *Year* | *Price (cents per lb.)* | *Compared to Year Preceding* | *Compared to 1939* |
|---|---|---|---|
| 1939 | 36.0 | | |
| 1940 | 36.4 | +0.4¢ | +0.4¢ |
| 1941 | 39.1 | +2.7¢ | +3.1¢ |
| 1942 | 43.5 | +4.4¢ | +7.5¢ |
| 1943 | 43.9 | +0.4¢ | +7.9¢ |
| 1944 | 41.4 | −2.5¢ | +5.4¢ |
| 1945 | 40.6 | −0.8¢ | +4.6¢ |
| 1946 | 50.1 | +9.5¢ | +14.1¢ |
| 1947 | 67.1 | +17.0¢ | +31.1¢ |

In stating change, it is important to make clear with what previous figure a comparison is being made. The number with which comparison is made, the one which exists before a change takes place, is called the *base number*, and the year or period from which this number is taken is called the *base year* or the *base period.* For the third column of the

table the base number was the price in each preceding year and was therefore different for each computation. For the fourth column there was a common base number and base period for all; the base number was a price of 36.0 cents per pound and the base period was the year 1939. The practice of choosing one number as a common base for all computations of change makes for greater ease in interpretation, and is the method most generally used in presenting such statistics.

The second way of describing the degree of change is to show it as a relative change. A relative change expresses the ratio of two amounts, generally in the form of a percent. We may say, when a price rises from 36 cents to 72 cents, that the price has doubled. A much better way is to state it as a percent of increase or decrease; a rise from 36 cents to 72 cents is an increase of 100 percent. The following table shows the absolute and relative changes in the price of meat from 1939 to 1947, using 1939 as a base year.

AMOUNT AND PERCENT OF CHANGE IN RETAIL MEAT PRICES, 1939–47

(PRICE FOR BASE YEAR 1939 = 36.0 CENTS)

| *Year* | *Amount of Change (absolute) (in cents)* | *Percent of Change (relative)* |
|---|---|---|
| 1939 | — | — |
| 1940 | +0.4 | +1.1 |
| 1941 | +3.1 | +8.6 |
| 1942 | +7.5 | +20.8 |
| 1943 | +7.9 | +21.9 |
| 1944 | +5.4 | +15.0 |
| 1945 | +4.6 | +12.7 |
| 1946 | +14.1 | +39.1 |
| 1947 | +31.1 | +86.6 |

The percentage change in each case may be figured by following a simple arithmetic formula:

$$\frac{\text{Amount of change from base year}}{\text{Amount in the base year}} = \text{percent change}$$

Thus in 1944, the price was 5.4 cents greater than the price of 36 cents prevailing in 1939, the base year. Applying the formula, we find:

$$\frac{5.4 \text{ cents}}{36.0 \text{ cents}} = .15, \text{ or 15 percent, the rate or percent of increase}$$

The 1944 price can also be expressed as 115 compared to 100 in the base year. In that case 115 is called a *relative number*. A relative number shows the size of a number when compared to another one, which is

always considered equal to 100. Actually the relative number shows what percentage the amount in a given period is of the amount in the base period, but with the word "percent," or the percent sign, left out. The computation of a relative number, therefore, uses the following formula:

$$\frac{\text{Amount for a given period}}{\text{Amount in the base period}} \times 100 = \text{relative number}$$

$$\frac{\text{Price in 1944}}{\text{Price in 1939}} = \frac{41.4 \text{ cents}}{36.0 \text{ cents}} = 1.15$$

$$1.15 \times 100 = 115, \text{ relative number for 1944}$$

Using relative numbers is the most convenient way of showing rates of change compared to a common base. In the first place, relative numbers are likely to be whole numbers; instead of saying a number is 1½ times the base, we can say that it is 150 compared to 100. Secondly, using relative numbers helps to limit the use of decimal points and the inconvenience of repeating percent signs; a relative number may be stated simply as 115, not as 1.15 or as 115 percent. In the third place, use of the relative number makes it easy to tell whether there has been an increase or decrease without using plus or minus signs. Thus a relative number of 115 means an increase of 15 percent above the base year (115 − 100 = 15), and a relative number of 72 means a decrease of 28 percent below the base year (100 − 72 = 28). Below is a table of relative numbers stating in different form the same facts shown in the table of percent changes in meat prices which appeared on page 43: (Numbers after the decimal point have been dropped for simplicity.)

RELATIVE NUMBERS OF MEAT PRICES, 1939–47

1939 = 100

| | |
|---|---|
| 1940 | 101 |
| 1941 | 108 |
| 1942 | 120 |
| 1943 | 121 |
| 1944 | 115 |
| 1945 | 112 |
| 1946 | 139 |
| 1947 | 186 |

It will be seen that comparisons among the different years, and between each year and the base year, are clearer when expressed in relative numbers than in any of the previous forms.

However, one caution should be emphasized: Relative numbers show the percent change from the base year only. In this table the relative number for 1946 is 139, and the relative number for 1947 is 186—a dif-

ference of 47. This does not mean an increase of 47 percent in 1947 compared to 1946. The relative numbers show that the price was 39 percent higher in 1946 than in 1939 (139 − 100 = 39), and that the price was 86 percent higher in 1947 than in 1939 (186 − 100 = 86). To find the percent change in 1947 compared to 1946, we would have to make the same computation that is necessary for any percent change.

$$\frac{\text{Amount of change}}{\text{Amount before change}} = \frac{(186 - 139)}{139} = \frac{47}{139} = .34 = 34 \text{ percent increase}$$

A difference of 47 points between the two relative numbers turns out to be a change of 34 percent.

### Using Index Numbers

The most common way of measuring change in complex economic factors is through the *index number.* An index number is an average of relative numbers.

The table on page 44 showed the use of relative numbers to measure the changes in the price of meat. Suppose the problem called for measuring the rate of change in different kinds of food; for example, meat, eggs, and milk. The prices of these items cannot be averaged together; because meat is sold by the pound, eggs by the dozen, and milk by the quart. This problem can be solved, however, by reducing the price of each article to a relative number. The relative numbers of the price of meat, eggs, and milk in 1944 are stated, and the index number is computed:

| | |
|---|---|
| Meat | 115 |
| Eggs | 169 |
| Milk | 128 |
| Total | 412 divided by 3 = 137, index number |

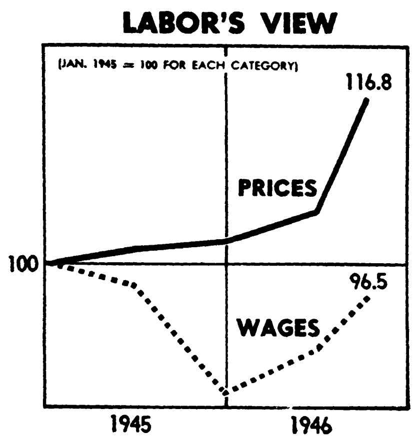
The following table shows the index numbers for these three products for the years 1939 to 1947, with 1939 as the base year:

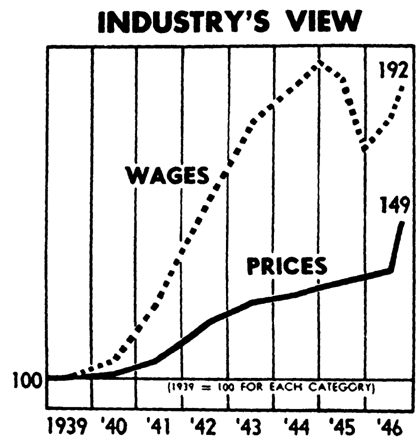
Changes in the Price of Meat, Eggs, and Milk, 1939–47
(1939 = base year)

| | Relative Numbers | | | Meat-Eggs-Milk |
|---|---|---|---|---|
| *Year* | *Meat* | *Eggs* | *Milk* | *Index Number* |
| 1939 | 100 | 100 | 100 | 100 |
| 1940 | 101 | 103 | 105 | 103 |
| 1941 | 108 | 123 | 111 | 114 |
| 1942 | 120 | 150 | 123 | 131 |
| 1943 | 121 | 178 | 127 | 142 |
| 1944 | 115 | 169 | 128 | 137 |
| 1945 | 112 | 181 | 128 | 140 |
| 1946 | 139 | 182 | 144 | 155 |
| 1947 | 186 | 189 | 160 | 178 |

The above table of index numbers has a limited value, however, because of two factors. For one thing, an index number of food prices based on only three items does not necessarily show the changes in prices of food in general. Furthermore, the method used for computing the index numbers in the above table was that of the simple, unweighted arithmetic mean. The prices of meat, eggs, and milk were given equal weight.

When the index number of consumer prices is computed by the Bureau of Labor Statistics, both these factors are taken into account. The




Charts by GRAPHICS INSTITUTE, N. Y.

**With identical data but different base periods a newspaper presented these seemingly opposite views. Note that in Jan., 1945, (right graph) wage rates began to drop, while prices still rose. This explains why, with Jan., 1945, as base period (left graph), prices appear above wages. But as compared with 1939, wages had risen more than prices. Comparison and interpretation are easier and more likely to avoid error if the same base period is used.**

index number is based on many hundreds of items, which together make a representative sample of the average family's spending. Each item is weighted on the basis of studies which have been made by the Bureau of the amounts spent by typical families for food, clothing, housing, and other items. Food ordinarily takes from two to three times as much of the family budget as clothing; and some food items are much more important than others. The consumer price index reflects these differences in importance.

The reader of statistics must also remember that a change in the index number does not prove that every item included in it changed in the same way. In 1944 in the table above, the index number dropped compared to the previous year; the price of milk, however, rose for that

period. Thus we must be careful not to make judgments about any particular part from what we know of the whole.

Comparison between two sets of index numbers is difficult unless the base periods are the same in both cases. The graph on page 46 illustrates the danger of shifting the base period. The difference in the points of view of labor and industry shown on the graph lies not in the fact that the data were different, but in the fact that different base periods were chosen for the same data.

It must always be realized that index numbers show relative size, not absolute size. The fact that the index and the relative numbers for meat, eggs, and milk in the table on page 45 were all 100 in 1939 does not mean that the prices in dollars and cents were all the same. Actually, in 1939 the price of meat was 36 cents per pound, eggs were 32 cents per dozen, and milk 12 cents per quart. In 1947 the relative number for meat prices was 186 compared to a relative number of 189 for milk prices; the actual price of steak was almost 68 cents per pound, compared to less than 20 cents per quart for milk.[1] To judge absolute prices from relative numbers or index numbers would clearly be wrong.

### Statistical Correlation

When two sets of statistical facts are connected in their movements the statistician may say that there is a high *correlation* between them. By correlation he means that changes in one set of facts are accompanied by changes in the other. The correlation may be *direct,* meaning that when one rises or falls, the other moves in the same direction; or it may be *inverse,* meaning that when one rises or falls, the other moves in the opposite direction.

The mere fact of statistical correlation does not prove that one factor causes the other. It may be that the changes in both factors are the result of changes in a third factor. If it is shown that a rise in prices is accompanied by a rise in wages, we should say that there is a direct correlation between price increases and wage increases. This is not the same as saying that rising prices cause rising wages or that rising wages cause rising prices. To say this would first require further investigation of the reasons for the occurrence of the statistical correlation. The statistician and the economic theorist must work together, for statistics provide a way of verifying theory.

## Exercises and Activities

I Dictionary of Economic Terms

| | |
|---|---|
| absolute change | index number |
| base number, year, or period | inverse correlation |

[1] *Information Please Almanac 1948,* Doubleday & Company, Inc., p. 367.

correlation
direct correlation
relative change
relative number

## II Questions and Problems

1) Using the data in the table, answer the questions which follow:

**Retail-Store Population, 1915 and 1935, 32 Towns***

| | *General Stores* | *Drug* | *Men's Clothing* | *Dry Goods* | *Shoes* | *Women's Wear* | *Hard-ware* |
|---|---|---|---|---|---|---|---|
| Number in 1915 | 671 | 143 | 128 | 124 | 88 | 22 | 110 |
| Number in 1935 | 898 | 138 | 87 | 55 | 59 | 73 | 80 |

* Source: Dun and Bradstreet, Inc.

(a) Explain, and give examples of, the difference between absolute change and relative change. (b) Which showed a greater absolute decrease, hardware or shoe stores? Which showed a greater relative decrease? (c) Explain the steps in preparing an index number for the retail stores in existence in 1935, with 1915 as the base year.

2) Explain whether the statements below the table are true or false according to the figures in the table:

**Index Numbers of Industrial Production (1935–39 = 100)***

| Industry | 1943 | 1944 | 1945 | 1946 |
|---|---|---|---|---|
| Fuels | 132 | 145 | 143 | 137 |
| Processed Foods | 145 | 152 | 150 | 150 |
| Metals | 126 | 113 | 101 | 88 |

*Source: Board of Governors, Federal Reserve System

(a) All industries were producing more than in the base period. (b) Manufactured foods were produced in the same quantity in 1945 and 1946. (c) The production of fuels in 1944 was the same as the production of manufactured foods in 1943. (d) The production of fuels dropped 6% in 1946 compared to 1945.

3) Draw a graph based on the figures given in Question 1 or 2.

## III Things To Do

1) In a newspaper find examples of the use of index numbers.
2) Copy the following headings and supply the requested information about three tables or graphs in this book. Note example.

| Economic Factor | Base Period | Prepared by | Page in Book |
|---|---|---|---|
| Industrial Production | 1935–39 | Federal Reserve Board | 48 |

# *UNIT* 3

## STANDARDS OF LIVING

*7* WHAT ARE STANDARDS OF LIVING?

*8* WHY STANDARDS OF LIVING DIFFER

*9* NATIONAL PRODUCT AND NATIONAL INCOME

*10* INCOME AND EXPENDITURE

*11* THE AMERICAN STANDARD OF LIVING

*12* HOUSING AND STANDARDS OF LIVING

# LESSON 7 WHAT ARE STANDARDS OF LIVING?

## The Meaning of Standard of Living

If you compare your family with others you know—for the foods they eat, the clothes they wear, the homes they live in, the furnishings they use, the recreations they pursue—you will observe that there are differences. Each family has a distinctive mode or level of consumption which we call its *standard of living.* A standard of living may be defined as the quantity and quality of goods to which one has become accustomed and which one is generally able to acquire.

The attempt to maintain and improve the standard of living is the main incentive for work. People resist any downward change; during the hard times of the 1930's many families had to reduce their standards of living; it took many unhappy months to make the adjustments. When times were better, during the 1940's, there had to be another adjustment, a pleasanter and swifter one, to a higher standard of living.

The elements making up a family's standard of living are many and complex. It has been impossible, therefore, to measure standards of living with a numerical scale, like the thermometer scale used by scientists for measuring temperature. Some items related to standards of living can be measured; for example, the calories or vitamin content in food, the tensile strength of cloth, or the number of square feet of living space. Such measures, however, cannot adequately represent the satisfactions received by the consumer of food, clothing, or housing. Bread, rice, oatmeal, corn, cassava, macaroni, and other starchy foods contain the same basic food elements; a hut and a mansion both provide shelter; yet how differently they are viewed by different people. Standards of living can be measured only in a rough way by comparing one standard to another, and by setting forth general comparative descriptions rather than definite numbers on a standard scale.

## Classifying Standards of Living

It is possible to divide standards of living into roughly five groups. The basis for classification is how well the family income is able to satisfy the basic needs for food, clothing, and housing, and in addition provide luxury items and savings. The boundary lines between the groups are not hard and fast. In fact, it is not easy to tell exactly where one standard of living ends and the next one begins. One group merges gradually into the next, as do the colors in the rainbow.

*Poverty* is the standard of living at which the family is not able to

provide itself with the necessities of life out of its own income. A family living at this level depends upon outside help for part of its needs—upon contributions from relatives, friends, charitable organizations, and public relief. The food is insufficient, of poor quality, and the diet frequently unbalanced. Hunger is familiar to such a family. Its members are the most frequent sufferers from diseases caused by malnutrition. They live in the slums of the cities and in the poorest of rural shacks. New clothing is a rare luxury. They seldom visit doctors and dentists, and any medical treatment they receive is likely to be at the free public clinics. The family on the poverty level must struggle to live from one day to the next.

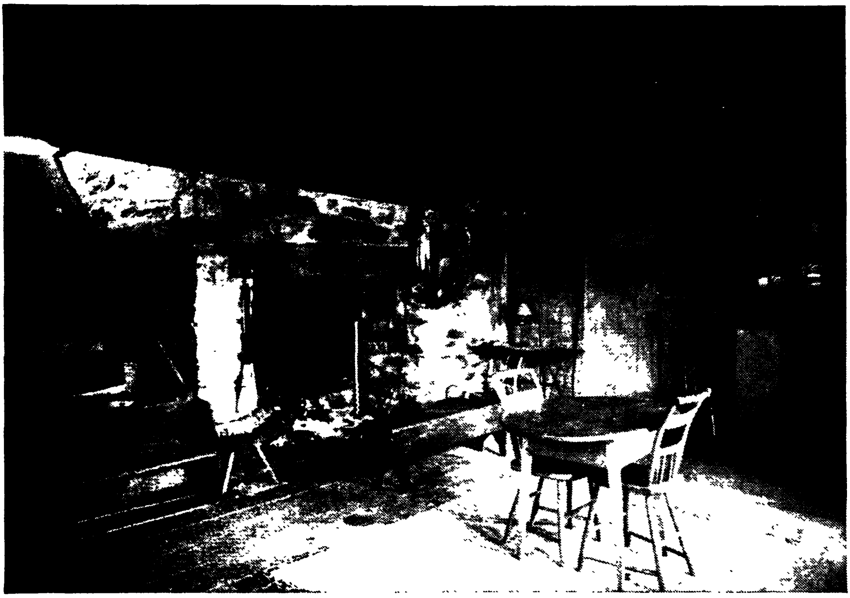
*Subsistence* is the standard of living at which the family has just enough income to get necessities without outside help. The essential difference between this level and the poverty level is that the continuous reliance upon public or private assistance is not present. Borrowing to meet minor emergencies is common. The quality of food obtainable is fair, the quantity usually sufficient. Clothing is just adequate, with very few new garments bought each year. Housing is still poor. Income is insufficient to leave any savings for even a little security. Existence is on the borderline where any major emergency, such as illness, birth, or death, will make the family seek outside help, and so force it down to the poverty level.

*Health and Decency* is the standard of living at which the family is able to buy necessities regularly out of its own income and have something left over for security and simple comforts. It can afford more food of better quality and greater variety than the two previous groups. The home or apartment is simple but fairly comfortable and not overcrowded. It is equipped with sanitary plumbing and electricity. Furnishings are adequate and include a radio and some electrical aids to housekeeping. There is room in the budget for an insurance policy, magazine purchases or subscriptions, and a few forms of recreation. The family situation permits the children to complete high school without the necessity for after-school work. Successful living in this family depends very strongly upon skillful management of income and wise family buying.

*Comfort* is the standard of living at which the family can take for granted the necessities of life and can provide, with some leeway, for savings and luxuries. Some of these luxuries, indeed, are thought of as necessities. Food is richer, more carefully prepared, and sometimes too plentiful for health and figure. Clothing can be bought on the basis of style rather than cheapness and durability. The family can afford to live in a good neighborhood and buy up-to-date labor-saving equipment. Furnishings are more comfortable and richer in appearance. Sav-

ings accounts and insurance policies protect the family against emergencies and provide a nest egg for a new home, a new piece of household equipment, an automobile, television, travel, or vacations. College education for sons and daughters is not unusual. At this level "wanting" is only for expensive luxuries.

*Wealth* is the standard of living at which not only the necessities of life and provision for security are taken for granted, but ample luxuries as well. Food, clothing, living quarters, education, recreation, and in-



*Library of Congress, photo by Rainey*

The kitchen and "living room" of a Connecticut home built in 1670. In what respects does it differ from a modern kitchen and living room? What conclusions, if any, can be drawn about the standard of living of its occupants in colonial times?

vestment for the future can be provided lavishly. Families can afford the money and the time to partake generously of such cultural advantages as concerts, the theater, and travel. This is the standard of living made familiar by many of our motion pictures and the society pages of newspapers. Its distinguishing features are exclusiveness, richness, a constant search for something new. Savings and invested wealth tend to be largest in this group, and in these fa nilies ways and means of investing wealth become a very important consideration.

## The Relative Nature of Standards of Living

A family's standard of living is a measure of goods and services that it customarily consumes. A very high standard of living does not neces-

sarily mean that the members of the family are content and well-adjusted. Life cannot exist without food, clothing, and shelter. However, the types of food, clothing, and shelter which will make for greatest satisfaction for any one family depend upon the time, the place, and the circumstances involved.

In comparing standards of living today with those of earlier times, the tastes and customary consumption of each period must be taken into consideration. Poor families today take for granted goods and services undreamed of by the well-to-do of earlier generations. This may be seen from the following description of living standards of professional men in this country in the early part of the last century:[1]

> The homes of such professional men would now be considered plain in the extreme, lacking all luxuries and many things regarded as essentials today. The farmers and mechanics of that time found clean sand a substitute for carpets, and pewter or wooden dishes sufficient for tablewear. There was no linen on the table or prints on the walls; nor many books, nor any periodicals. Except for hats and shoes (which were made and sold at the village shop), all of the clothing of the family was homemade. The three meals of the day were from varying combinations of salt pork, salt fish, potatoes and turnips, rye bread, and dried apples, with fresh meat perhaps once a week. Not yet known were cauliflower, sweet corn, lettuce, canteloupes, and tomatoes; while tropical fruits like oranges and bananas were the rare luxuries of the rich. Even the rich could not have ice in the summer. In the cities a small class of merchants had spacious homes, silver-laden tables, and on occasion crimson attire. The great planters of the South, too, lived in open-handed wastefulness, but with little real comfort.

It is clear that a poverty standard of living in 1950 is a much better standard than poverty was a century ago and that it contains many features not even included in comfort and well-to-do standards of that day. That, however, will not serve to make the poor family today any happier with its lot, for it compares the goods and services it is able to consume with those that the customs and traditions of the present day have made it want. Comparisons with a previous century are useful as a measure of national progress but they cannot serve to measure relative standards of living as they exist today.

A similar difficulty confronts one in attempting to compare standards of living in different places or different countries at the same time. Such comparisons are most meaningful when the customs and traditions of the two countries are not too far apart. The customary diet of a Japanese, Chinese, or Indian family is considerably different from that of an American family. The Asiatic families do not have the income to secure

[1] Willis M. West, *History of the American Nation*, Ronald Press, 1929, pp. 385–386.

the same quantity and quality of foods as Americans, but they do not like and do not want the same foods. The same may be said of clothing, housing, and other goods and services. If we consider automobile ownership to be a symbol of a high standard of living in American cities, we must remember that in other countries it may not be considered as such. If the number of guns owned per family were to be used as a measure, the residents of New York City would not compare favorably with the people of the Southern highlands. In other words, in comparing goods and services consumed, as a means of getting a picture of varying standards of living, it must be remembered that standards of living are relative to the customs, traditions, and wants of the region.

On the other hand, the relative nature of standards of living must not lead us to conclude that differences are entirely the result of differences in taste. It may be true that automobiles and radios are not so important to the Chinese or Balkan peasant family as to the American family; but that results partly from the Chinese or Balkan family's unfamiliarity with the satisfactions which come from such goods, and partly from their being unable to own these goods. As standards of living rise, perhaps such goods will become a more and more important part of wants throughout the world.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | |
|---|---|
| comfort | standard of living |
| health and decency | subsistence |
| poverty | wealth |

II QUESTIONS AND PROBLEMS

1) "What is necessity to one family is luxury to another." (a) Explain this statement and give examples. (b) Why are "necessity" and "luxury" relative terms?
2) Copy the following table and fill in the blank columns:

| STANDARD | HOW ADEQUATE IS THE INCOME OF THE FAMILY TO PROVIDE | | |
|---|---|---|---|
| | *Necessities?* | *Security?* | *Regular luxuries & savings?* |
| Poverty | | | |
| Subsistence | | | |
| Health and Decency | | | |
| Comfort | | | |
| Wealth | | | |

3) Some believe that sharp differences in standards of living are bad for the community. Some think such differences necessary, and even of value to the community. What is your opinion? State your reasons.
4) Select any movie you have seen recently. Which standards of living were shown? Prove your answer. Did the film indicate what jobs the characters held, and what incomes they received? If so, did these facts seem to correspond with the standards of living that were pictured?
5) Select a family from a movie, book, or play, to illustrate each of the standard-of-living groups described in Lesson 7. Justify your choices.
6) "The higher the standards of living in a country, the more efficient its economic system." Do you agree? Explain.

### III Things To Do

1) Begin to keep a scrapbook of material describing or explaining different standards of living. Newspaper and magazine items and clippings are a rich source of information. Quotations from literature and history books are another source.
2) Make a display of advertisements which show, by price and type of goods advertised, that there are wide contrasts in standards of living.
3) Read (a) *American Economic Life and the Means of Its Improvement*, a college textbook by Tugwell, Munro, Thomas, and Stryker (Harcourt, Brace, 1930), "Rural Poverty," pp. 67–95; "Urban Poverty," pp. 96–123; "Comfort," pp. 124–153; "Riches," pp. 164–166. (b) *Mexico: A Study of Two Americas*, by Stuart Chase and Marian Tyler (Macmillan). Many travel books, or books in geography, anthropology, or history give contrasts between new and old standards. (c) *Middletown* by R. S. and H. M. Lynd (Harcourt, Brace). This is a famous study of a typical city in the United States during the 1920's. It contains original and interesting statistical studies based on the use of the questionnaire and interview.

## *LESSON* 8 WHY STANDARDS OF LIVING DIFFER

### Family Income and Spending

The greater the number of dollars in the family income, the higher its standard of living can be. Money income is the factor, more than any other, which explains why standards of living differ from family to family.

Family income may come from one person or may be the combined contributions of several family members. It may consist of wages, tips, unemployment-insurance payments, pensions, receipts from insurance policies, relief payments, charitable contributions, or gifts. The income

may be the profits of a business in which a family member has a share. It may be rent from property, royalties from writings or inventions, or interest on money loaned. Occasionally the money income may be supplemented by goods and services received instead of money. This is called *income-in-kind.* The grocery clerk who is given unsold bread at the end of the day, the apartment-house superintendent who occupies his apartment rent free, and the farmer or suburbanite who grows his own vegetables, are receiving income-in-kind. Income-in-kind is a very important part of the income of farm families.

Goods and services which a family may use without any expense or production effort are called *free income.* Most often these are available at community expense; and, although they require expenditure to maintain, all members of the community are entitled to use them regardless of the amount paid as taxes. Such goods and services are provided by free public education, museums, libraries, beaches, parks, and playgrounds. In rural districts there are game, fish, lakes, skiing slopes, and so forth. The more free income is available and the more it is used by the family, the higher the standard of living can be.

Money income does not, however, provide a standard of living until it is spent on consumers' goods. The miser who hoards and counts his income but never spends it may get enjoyment from his peculiar behavior, but he has a low standard of living. The spendthrift, on the other hand, may someday pay the penalty for his waste, but meanwhile he enjoys a higher standard of living than other people with the same income. The businessman who invests his profits to enlarge his business may gain in the future, but if he currently abstains from spending on consumers' goods, his family's standard of living is kept down. Therefore, standards of living differ from family to family, not only because of differences in money income, but also because of different attitudes and habits toward spending and saving.

### The Cost of Living

Every housewife knows that spending a lot does not always mean buying a lot. When prices are high, less can be bought with the income than when prices are low. The quantity of goods and services that a money income can buy is called the *real income.* Mrs. John Doe carries her money income in her purse when she goes shopping; she brings home the real income in her shopping bag or cart. It is the real income which affects her family's standard of living most directly.

The money which must be paid for the goods and services that are included in the standard of living is called the *cost of living.* Cost of living is measured by an index number of prices of consumers' goods and services. (See page 46.)

Both money income and cost of living are constantly subject to change. The effect of such change on standards of living will depend on the amount and direction of change. The little sketch entitled "The Income Cost Meter" shows that cost of living pulls standard of living in one direction, while money income pulls it in the opposite direction. A higher cost of living pulls the standard of living down; rising money income pulls it in the direction of improvement. When both cost of living and money income are rising, whether standard of living will rise or fall depends upon which pull is stronger.

## THE INCOME COST METER

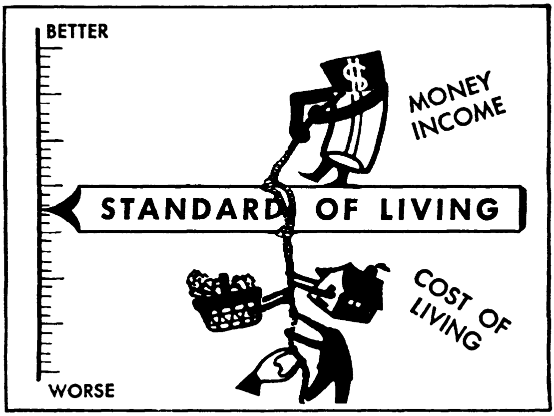



Chart by GRAPHICS INSTITUTE, N. Y.

**Rising income pulls living standards up; rising cost of living pulls standards down.**

The standards of living of all families are not equally affected by changes in the cost of living. In the first place, different types of income change at different rates. For example, civil-service workers have found that increases in their salaries lag behind rises in the cost of living. Farmers, on the other hand, have found that during periods of rising prices their incomes have forged ahead. In the second place, not all families react in the same way to rising costs of living. One family may find it easy to do without something that another family regards as essential. In the third place, a rise in cost of living does not mean that all goods and services rise equally. A large increase in milk prices means more to the family with young children than to the family consisting entirely of adults. In the fourth place, changes in the prices of goods have less effect on families receiving a large proportion of income-in-kind than on families which have to pay money for all the things they need. The family with a garden plot is less affected than the city family by an increase in the cost of fresh vegetables. Finally, the effect of rising or falling costs of living depends upon the size of the money income.

Where money income is very high, the only effect of rising costs may be to reduce savings. Where money income is very low, rising costs may reduce the buying of necessities.

SIZE, COMPOSITION, AND HEALTH OF THE FAMILY

The standard of living a family can attain with a given money income at existing prices depends partly upon the number in the family, its composition as to ages and sex, and the state of health of its members.

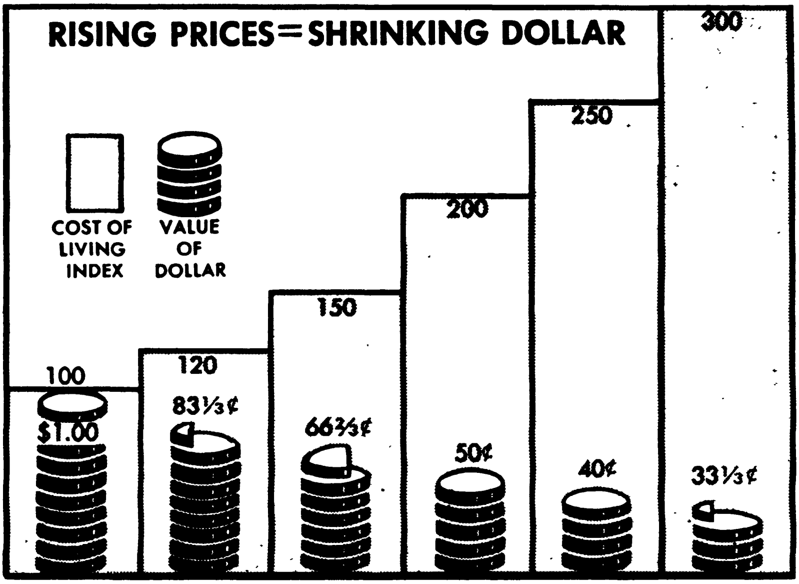



Chart by GRAPHICS INSTITUTE, N. Y.

The number of cents in a dollar is always 100. However, we often speak of the dollar as being worth fewer than 100 cents. The higher prices go, the lower the purchasing power of each dollar.

A family of ten requires more spending on food, clothing, rooms, and other things than does a family of three. On the other hand, a large family of adults has more income-earners and a larger family income. Large families with many young children tend to have lower standards of living than smaller families or large families made up mainly of adults.

Whether it is more expensive to support daughters or sons is a question parents will find it hard to agree upon. Much depends upon the ages of the children and upon the "social circle" in which the family moves. Daughters are as likely to be income-earners and contributors to family income as sons, but wages for women still tend in many instances to be lower than those for men. The expenditure required for clothing, entertainment, and education varies greatly, depending upon

the attitudes and associations of the family as well as upon the ages of the children.

The health status of the family is often a decisive factor. Illness of the chief breadwinner may shrink the family income. One invalid, requiring medical attention, may deprive the other members of the family of much-needed goods and services.

*Knott in* The Dallas Morning News

Why was this cartoon entitled "The Invisible Guest"?

SOCIAL STATUS AND INCOME MANAGEMENT

The social standards or requirements to which a family tries to conform may be referred to as its *social status.* Every community has its conventions or social requirements. Failure to conform to enough of these may mark a person as "not belonging." For most people the ability to live as part of the social group and to gain the esteem of others is necessary and provides a feeling of satisfaction.

Families buy and pay for this sense of belonging or social status. The dress with the "new look" is bought even though the closet may bulge with other dresses. The new model car is bought not just because it runs more efficiently; parked at the door it brings social prestige. The family must do the right amount and kind of entertaining even though it may cause considerable strain on the family income. Spending to impress others is called *conspicuous consumption* by Thorstein Veblen in his book *The Theory of the Leisure Class.*

The more skillfully and intelligently the family income is spent, the

higher the standard of living that a given income yields. In most families the housewife, buying the food and clothing at least for herself and the young children, is the chief manager of income spending. A glance through any current woman's magazine will reveal budget menus, shopping hints, patterns, recipes, articles on how to renovate clothing and furnishings, and other matters pertaining to the rather difficult task she has to perform. The good manager is an income stretcher; the careless manager is an income waster.

### General Factors Affecting Standards of Living

The factors determining a family's standard of living are subject to family control to a limited extent. The higher the family's income, the more opportunity the family has to make choices, such as how much to spend and how much to save. It can decide what types of goods it will buy. It can strive to increase income by changing the job or improving the skill of its members. It can decide whether to increase income by sending children to work, or to increase expense by sending them to college. More or less use can be made of the free income available. It can use or not use the wide variety of means available to the careful household manager.

In many respects, however, the factors affecting the family's standard of living are beyond its individual control. It cannot by itself influence changes in the cost of living. Bad business conditions resulting in wage shrinkage or unemployment may be the result of changes in foreign trade, of government tax policy, of business decisions, or of any number of other possible causes outside the control of the individual family. A drought in the corn belt, a killing frost in the fruit regions, a war in a country supplying raw materials or buying the products of our factories, may influence the family income or the amounts of goods available for purchase. The next lesson discusses some of the general factors affecting standards of living.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| conspicuous consumption | income-in-kind |
| cost of living | real income |
| free income | social status |

### II Questions and Problems

1) List the major factors influencing a family's standard of living and explain each in a sentence.

2) "Standards of living vary directly with income and inversely with cost of living." (a) Explain the above statement. (b) Using the term "inversely," state the relationship between cost of living and real income. Explain.
3) (a) Explain and give an example of conspicuous consumption. (b) Under what circumstances does conspicuous consumption tend to lower or to raise standards of living?
4) Is it fortunate or unfortunate for the community as a whole that social status plays such an important part in shaping our spending? Explain your opinion.
5) Clip an advertisement that, in your opinion, appeals to human desires to "consume conspicuously" or that suggests imitation of wealthier persons. Explain.
6) A great deal of controversy has raged over the desirability of a "welfare state," in which the government would provide more and more free income for its citizens. (a) Explain why more free income would be part of a "welfare state." (b) List arguments for and against the government's providing more and more free income.
7) Explain the possible effect of each of the following upon standards of living: (a) All merchants in the community agree to lower prices by 10%. (b) The government limits wages but does not control prices. (c) A free university is opened. (d) Anti-discrimination laws are passed by the state. (e) There is a long cold winter. (f) Courses in home economics are required for all girls. (g) A coal strike makes 300,000 miners idle for one month.
8) Explain the meaning of the cartoon on page 60.

## III Things To Do

1) Study the following table.

Purchasing Value of the Consumer's Dollar, 1929–1947*
(1935–39 = 100)

| *Year* | *Cents* | *Year* | *Cents* | *Year* | *Cents* | *Year* | *Cents* | *Year* | *Cents* |
|---|---|---|---|---|---|---|---|---|---|
| 1929 | 84.2 | 1933 | 112.9 | 1937 | 96.6 | 1941 | 94.8 | 1945 | 78.7 |
| 1930 | 87.1 | 1934 | 106.6 | 1938 | 99.2 | 1942 | 85.7 | 1946 | 73.7 |
| 1931 | 96.9 | 1935 | 103.0 | 1939 | 100.5 | 1943 | 81.0 | 1947 | 65.2 |
| 1932 | 108.5 | 1936 | 100.8 | 1940 | 99.7 | 1944 | 80.0 | 1948 | 61.4† |

* Source: Bureau of Labor Statistics † 1948 for first 9 months only

(a) Prepare an analysis of these figures, showing the effect of these changes on standards of living. (b) Draw a graph based on the table above.

2) Draw an original cartoon explaining the effects on standards of living of one of the following: (a) conspicuous consumption, (b) size of family, (c) business conditions, (d) low standards in other parts of the country.

# LESSON 9 NATIONAL PRODUCT AND NATIONAL INCOME

## Production and Consumption

You will see a good picture of the wide variety of goods contributing to American standards of living if you thumb through the fascinating pages of the catalogs of our giant mail-order companies. If it were possible to compile such a volume showing the name and description of every commodity and service produced in this country and the number of each made or performed during the year, we would have a listing or inventory of the nation's entire production. The greater this total of goods and services produced, the higher it is possible for standards of living to be. In the final analysis, there can be no consumption without production.

Four general factors determine, over the long run, the production of a nation and its standards of living. These are (1) the natural resources, (2) the population, (3) the technology, and (4) the economic system.

Where natural resources, or gifts of nature, are rich, it is easier to produce many and varied goods and to provide the means for high standards of living. The United States has many acres of fertile land. Its growing seasons are long enough, its climate varied enough, to permit the growing of a wide variety of crops providing food and raw materials. Mineral raw materials and fuels are present in great quantity—coal, oil, copper, lead, zinc, and others. There are still many acres of forest and woodland. Although we do face the challenges of mountain, desert, and swamp, nature has been generous, by and large, in bestowing her gifts on our land. Some other countries are not equally fortunate; frozen waste makes up the bulk of Canada and Siberia; North Africa and Australia are mainly desert; much of Brazil is impenetrable jungle; Germany for the most part suffers from poor soils; Italy, Greece, and Japan must cope with rugged hills and mountains.

A second factor of importance in judging a nation's ability to produce goods and to provide high standards of living is its human resources, or the quantity and quality of its population. Large population means a large labor supply. How great a contribution this labor supply can make to production depends not only on the number of people but also upon their skill and training. No doubt the American educational system deserves part of the credit for the high level of American production. On the other hand, a large population means a large consuming public—more people to share in the output.

A third factor is the nation's technology. *Technology* is the applica-

tion of scientific knowledge to industry. The United States owes its high standards of living partly to the highly developed use of factories and machines.

The final and the most complex of all the factors affecting the ability of a nation to produce goods and provide high standards of living is the economic system in use. Capitalism, socialism, fascism, and communism are varied ways of organizing the resources, the technology, and the labor supply for purposes of production, and of providing for the consumption of the goods produced.

### National Product and National Income

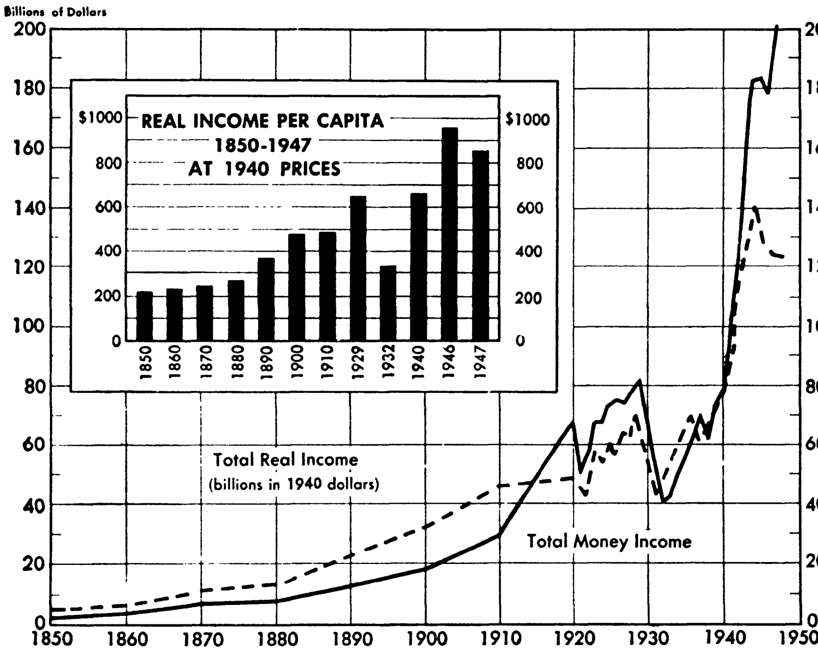
A description of total national production, in the form of a complete list of all goods and services produced in our country, would be impractical to prepare, and confusing and inconvenient to use. It would be impossible to summarize such unlike items as washing machines, quarts of milk, haircuts, bushels of wheat, books, and so forth. It is possible, however, to get a better pricture of the total production by adding up so many dollars' worth of each commodity in order to get a dollar total. The total dollar value of all the goods and services produced during the year by all the producers in the nation is called the *gross national product.*

Every person who contributes to the production of the goods and services which make up the gross national product receives some sort of payment. Workers receive wages or salaries, businessmen receive profits, investors and owners of capital receive dividends or interest, and landlords receive rent. These payments are in the form of money, which is simply a right to buy the goods and services making up the national product. If we add up all the money incomes received in the nation by all these income-receivers, the total may be called the *national income,* or to be more specific, the *money national income.* The amount of money received will not be exactly equal to the value of the gross national product, because some of the national production must go into the repair and maintenance of the machines and equipment used to produce the goods. The national income received gives an indication of the production of goods and services even though it may not represent accurately the exact value of the goods produced. The larger the national product, the larger the national income, for more production means that more is paid out as wages, salaries, profits, rents, and other payments to those who assist in the production process. An increase in national income therefore is likely to reflect an increase in the amount of goods and services produced. And the higher the national income, the greater the possibility of high standards of living.

This exact relationship will exist, however, only when the prices of

the goods produced do not change. In 1920 and in 1930 the dollar total of national income was approximately the same, 69 billion dollars. At first glance this would make it seem that the national production of goods and services was the same in both years. However, in 1920, prices were higher than in 1930. Every dollar of 1930 national income

## TOTAL AND PER CAPITA NATIONAL INCOME, 1850-1947




The solid line graph shows money national income; the dotted line graph shows what money national income would have been if prices were always the same as they were in 1940. Why is the dotted line a better index of improvement in standards of living? The bar chart shows how much each individual in the population could have received if national income (at 1940 prices) were equally divided. (Data from Twentieth Century Fund)

was worth more in goods than a dollar of 1920 national income. Therefore 69 billion dollars' worth of goods and services in 1930 meant more goods and services than 69 billion dollars' worth in 1920. The actual amount of goods and services that could be bought with a given number of dollars, that is, the *real national income,* was considerably greater in 1930 than in 1920.

The real national income is therefore a better index of changes in the amount of goods produced and consumed than the money national income. To get an index of real national income, we must make adjustments in the dollar totals of the money national income in order to com-

pensate for price changes. This is done in much the same way as we make index numbers (see Lesson 6). We take any year as a base and change all amounts in other years to what they would be if prices were the same as in the base year. We may then set forth the national income for each year in "constant dollars." In the graph of national income on page 65, the dotted line is the index of real national income and is based on constant "1940 dollars." This means that the totals of the money national income shown by the solid line were adjusted to show what they would have been if prices had always been the same as in 1940.

Study of the real national income on the graph (the dotted line) shows that the general trend in this country has been upward. In the upper left hand corner of the graph is a small bar chart showing the *per-capita*, or per-person, real income. This has been computed by dividing the real national income by the population. It shows that the increase in production has been large enough to provide more real income per person, even though the population or the number of persons sharing the real income has gone up. This too is a measure of the progress of American living standards.

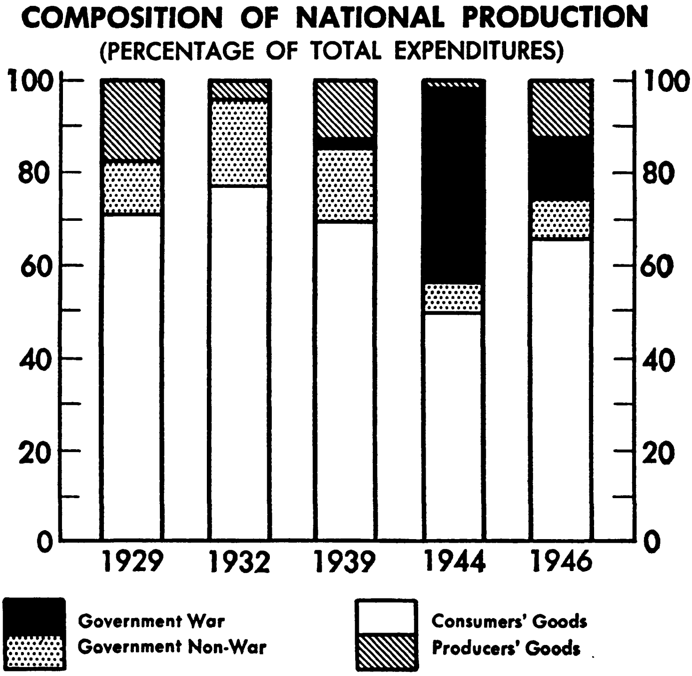
### Composition of National Product

The level of living standards in the nation can be high for any length of time only if production of goods and services is high. Whether standards of living will actually be high depends also upon the kinds of goods produced, that is, upon the composition of the national product.

The first consideration of importance is the proportion of *consumers' goods* and *capital goods* produced. Food, passenger automobiles, and clothing are examples of consumers' goods, which are goods meant to be finally used up as part of the individual's standard of living. Steam shovels, printing presses, tractors, and factory buildings are examples of capital goods, or *producers' goods,* which are goods used only in producing other goods or services. The standards of living of consumers depend immediately upon the amount of consumers' goods in the national product. Over a period of time, increasing the proportion of producers' goods will increase the means of producing goods for consumers and will help keep the plants, farms, and mines in repair. But in the immediate present a large production of capital goods and a small production of consumers' goods means that standards of living cannot be high even if total production is great. Nations which are in the process of building up their machines and factories, or nations which are in the process of restoring them after the destruction wrought by war, have to curtail the production of consumers' goods. Consequently, they have

lower standards of living than would be possible if with the same total production they produced more consumers' goods.

A second reason why high national production does not necessarily result in high standards of living is the fact that much of a nation's production may be devoted to military goods and weapons rather than civilian supplies and services. The war years in this country saw many shortages at a time when national production was at the highest point




This 100%-bar chart shows the proportions each year, but they are proportions of different totals. A larger proportion of consumers' goods was produced in 1932 than in 1944. However, more consumers' goods were available in 1944 because total production was several times greater. (See graph, p. 65.) (Data from U.S. Dept. of Commerce)

in our history. In Hitler's Germany the slogan was "guns instead of butter," and the government boasted of its schemes for depriving consumers in order to build military might. A nation at war or in fear of war must pay for its security partly by standards of living which are lower than they would be if the same effort were devoted entirely to civilian production.

A third factor which may affect standards of living by its effect on the composition of goods available is foreign trade. When we export cotton, steel, typewriters, electrical equipment, and other goods which we have in surplus, we get the income with which to buy the things we

cannot so easily produce in sufficient quantity, such as hemp, rubber, bananas, tin. Foreign trade results in an exchange of part of our national product for the national product of other countries.

Finally, the welfare of consumers depends upon the kinds of goods produced. Too much wheat, too little steel—too many automobiles, too few houses—such failure to adjust production to the needs and wants of consumers results in shortages or surpluses and may bring losses to businessmen and keep standards of living down. For the maximum welfare of consumers, the right kinds and quantities of consumers' goods must be produced.

### Distribution of National Income

It is possible, even with a large national production and income, for some people to receive large shares and for others to receive small shares. The number of families with high standards of living and the number of families with lower standards of living depend upon the way in which the money national income is distributed or shared.

The steelworker who contributes to the making of steel receives a money wage which he can exchange for food, clothing, and the other goods and services which make up his standard of living. The payment of money incomes, as wages, profits, interest, rents, and so forth, is the means by which the real national income or product is shared. It determines how many will be well-off and how many will live poorly; it determines who will have a high standard and who will have a low standard. The amount of national production and the composition of national production are important factors in determining how high the average consumption can be, but to the individual family its share of the money national income and the prices it has to pay are the factors of primary and immediate concern.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| consumers' goods | producers' or capital goods |
| gross national product | real national income |
| national income | technology |

### II Questions and Problems

1) What are the factors that make the gross national product of a nation high? Explain each briefly and give an example applying to the United States.
2) Explain why real national income is more significant than money national income in determining standards of living.

3) (a) What is the immediate effect, on standards of living, of a very large increase in the proportion of capital goods being produced? (b) Of a decrease in the amount of consumers' goods being produced? (c) What may be the effect, in future years, of an increase in capital goods production? Explain.
4) Explain the possible effects, on standards of living, of each of the following: (a) a long period of peace with threats of war absent; (b) a long period of drought ruining many crops; (c) a doubling of both exports and imports; (d) an increase in taxes to pay for dams and other projects to conserve and develop resources; (e) the scrapping of millions of dollars' worth of plants because new inventions made them obsolete.
5) Indicate what factors may explain the low standards of living of one of the following countries: (a) China, (b) India, (c) Mexico, (d) U.S.S.R., (e) Spain, (f) Italy.
6) Consult the graph of national income on page 65. (a) Find a period during which real national income changed faster than money national income. Consult the chart of prices on page 367 and explain this change. (b) Find a period during which the opposite was true and explain this too.
7) What is meant by the following title on a graph: "National Income in Constant Dollars—1926 equals 100"?
8) Consult the graph (on page 67) showing the composition of national production. (a) Which of the following statements are shown to be true by this graph? (For which statements are data lacking?) (1) The proportion of military goods produced was high in 1944. (2) The proportion of consumers' goods produced was low in 1944. (3) Prices were tending to rise in 1944. (4) Price controls were in effect in 1944.
   (b) If we assume all four statements to be correct, what, if any, is the connection among them?

## III Things To Do

1) Look up the index numbers of industrial production for the same years as are shown on the graph of national income on page 65. (Use the *World Almanac* or *Information Please Almanac*). To what extent does the graph of industrial production change in the same way as the graph of national income?
2) Read (a) *America's Primer,* by Morris L. Ernst (Putnam), a simple treatment of the nature of national income. (b) *Income and Economic Progress* (Public Affairs Pamphlet No. 1, Revised, 1943), gives a summary of a four-volume study by the Brookings Institution. (c) Chapters 2 and 3 of *Introduction to Economic Science*, by George Soule (Viking, 1949), explain in an interesting way the meaning and historical development of national income. (d) *U. S. A.: Measure of a Nation* by Carskadon and Modley (Twentieth Century Fund, 1949), especially Chapters 1, 2, 3, 14, and 21.

# *LESSON* 10 INCOME AND EXPENDITURE

## Budgeting and Spending

John Break-even, wage earner for his family of three, earned $2069 during 1944. Personal income taxes amounting to $119 were deducted in advance, so that $1950 remained to pay the family's expenses. Here is what his budget showed:

| | | |
|---|---|---|
| NET INCOME (FEDERAL TAX DEDUCTED) | | $1950 |
| Expenses | | |
| *Food:* | $733 | |
| This included meals at home, restaurant meals, and refreshments for guests and parties. | | |
| *Housing:* | 499 | |
| The chief item was rent for apartment. Heat, light, refrigeration expenses were included. Cleaning, supplies, and other expenses of household operation were $87. Maintenance and replacement of household furnishings cost $53. | | |
| *Clothing and Personal Care:* | 293 | |
| Clothing was $250. Cleaning, pressing, beauty parlor and barber visits, cosmetics and similar items were $43. | | |
| *Other Items:* | 425 | |
| Transportation cost $108; medical and dental care including drugs and supplies $105. Recreation, movies, toys, trips, vacations cost $90. Reading matter took $19 and formal education and school supplies $10. Gifts and contributions outside the family, including church donations, were $73. Miscellaneous small items totaled $20. | | |
| Total Expenses | | $1950 |

In this budget there was not enough income to put anything aside for savings; there was just enough to avoid borrowing or dipping into previous savings. It is doubtful whether any insurance policy could be paid for out of the $20 labeled "miscellaneous." Unless the terms of Mr. Break-even's employment included a policy paid for by the firm, no real, substantial provision could be made for family security.

This is not a make-believe wage earner and the expense budget is not an imaginary one. The budget is that of the city family of two or

more members, which was just able to break even according to a governmental study in 1944.[1]

Obviously the family income would not have been spent in exactly the same proportions if the income had been larger or smaller. The two graphs facing each other on pages 72–73 show in two different ways how expenditures for different purposes varied with income groups of different levels among city families in 1944. The bottom of each graph shows the income levels into which the families were grouped, as well as the average income earned by each group of families. Thus the lowest group included families with income less than $500 and their average income was $313; the highest group had incomes over $5000 and an average income of $7595.

The graph at the left shows what happened to expenditures in dollars as income rose. A glance from left to right within each classification of expense—food, housing, etc.—reveals that higher income meant more dollars spent for each item. Families with less than the "break-even income" of $1950 spent more than their incomes. They had *deficits,* or the opposite of savings. To support their extra purchases, they had to draw on any previous savings they may have had, receive assistance from public or private charities, borrow, or permit bills to go unpaid. In 1944 approximately 20 percent of city families had less than break-even incomes. Families above the break-even level had savings growing in amount as income rose.

The graph at the right compares the percentage of income, rather than the total number of dollars, spent for various purposes. As income increases, the percentage spent for food and for housing decreases. It is characteristic of expenditures for necessities that as income increases, the percentage of income spent declines. The percentage spent for clothing remains at about the same level, varying within the narrow limits of about 10 to 15 percent. Expenditure for other items in this war year, when luxury goods were scarce, failed to reveal the usual tendency to rise, but it will be observed that if net savings are included with other items, there is a steady rise in the percent of income devoted to it, from the lowest income group to the highest.

The first generalizations from family budgets were made a century ago by a German statistician, Ernst Engel. We still refer to them as *Engel's Laws,* which may be stated, as based on up-to-date figures, as follows:

As family income increases,
the percent spent for food decreases;

---

[1] "Expenditures and Savings of City Families in 1944," *Monthly Labor Review,* U.S. Department of Labor, January, 1946.

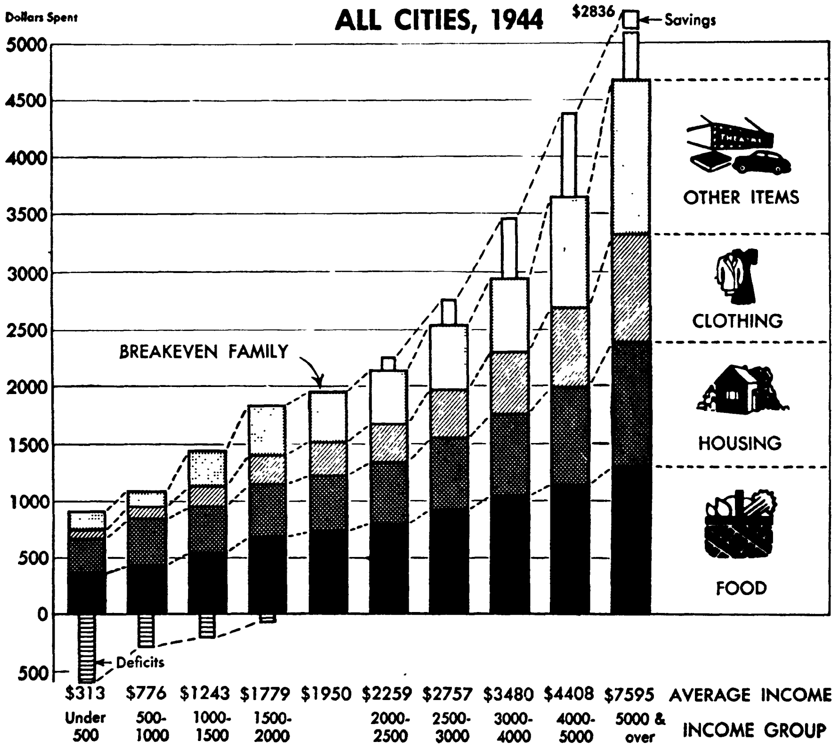
the percent spent for housing decreases;
the percent spent for clothing remains about the same;
the percent spent for luxury items increases;
the percent saved increases.

In briefer form they may be stated thus:

As family income increases,
the percent spent for necessities decreases, and
the percent spent for luxuries or saved increases.

There is a correlation between these percents and standards of living. One economist has gone so far as to say, "Whenever the expenditures

**DOLLAR EXPENDITURES BY FAMILIES OF 2 OR MORE, ALL CITIES, 1944**




The more dollars received, the more are spent in each division of the family budget. Rising income means disappearing deficits and increasing savings. (Data from U.S. Dept. of Labor)

for food exceed 50 percent of the total income, this may be taken as an almost certain index of poverty."[2] Among farm families who produce food for home use, the percent of cash income spent for food may be somewhat smaller, within any given income group, than in city families.

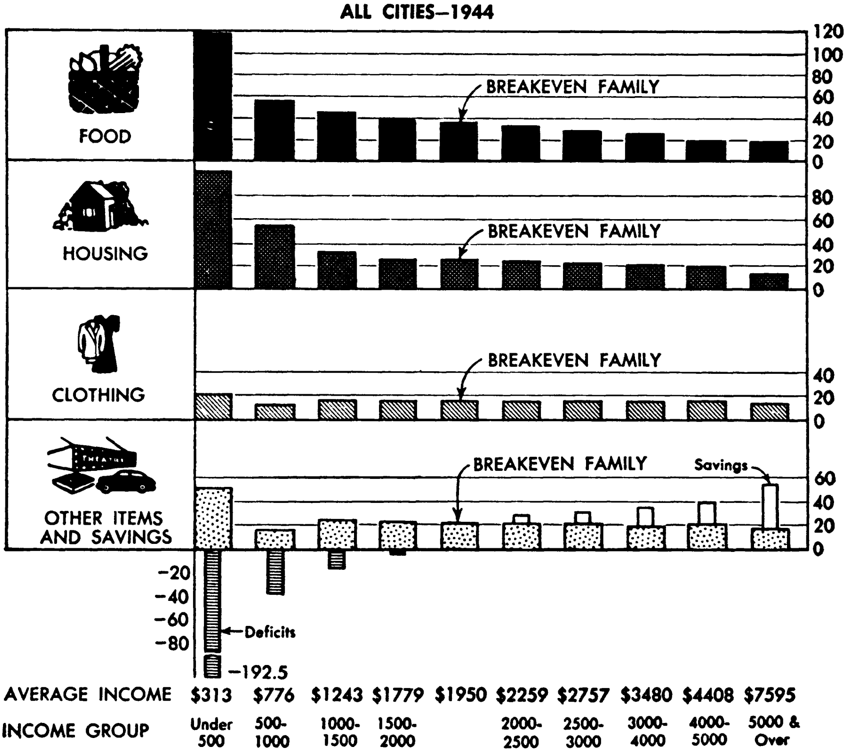
[2] Paul Nystrom, *Economics of Consumption*, Ronald Press, 1929, p. 282.

Housing is the second most important item in the family budget. In large cities particularly, the cost of housing tends to be high and the difference in the cost of housing is the chief explanation of the difference in cost of living from city to city. In middle income groups in large cities, the percent spent for housing will be in the neighborhood of 25 percent of income. Clothing expenditure seems to take from 10 to 15 percent of income and rarely reaches as high as 20 percent. The total of expenditures for food, housing, and clothing is from 70 to 80 percent of the total income in middle-income families.

The chart on page 74 summarizes an attempt by the National Industrial Conference Board to compare budgets of families in different

**PERCENTAGE EXPENDITURES BY FAMILIES OF TWO OR MORE**

**ALL CITIES—1944**

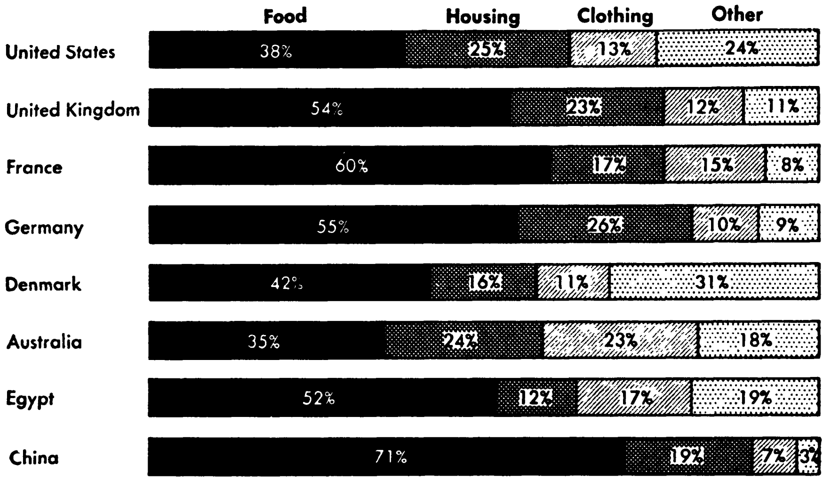



The more dollars received, the smaller the percentage of the income spent for food and housing, and the larger the percentage used for savings and "other items."

countries. The high status of American standards may be gauged from the relatively low percent spent on food and the high percent spent on "other" items. Only Australia shows a lower percent spent for food, and this figure is probably partly due to the higher proportion of farm families in Australia. The prevalence of subsistence farming in Egypt may

explain the fact that the percent spent for food in such a poor country is lower than that for the United Kingdom.

**PERCENTAGE DISTRIBUTION OF EXPENDITURES OF WAGE EARNERS FAMILIES IN VARIOUS COUNTRIES**




Larger percentages spent for food reflect lower standards of living. Note the contrast between the United States (top bar) and China (bottom bar). (Adapted from graph in *Domestic Commerce*, July 10, 1935; estimates of National Industrial Conference Board.)

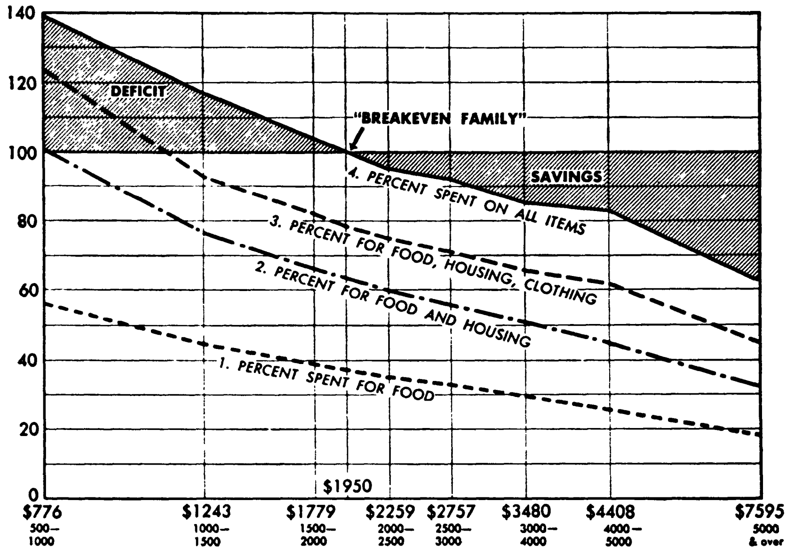
THE PRESSURE OF NEEDS

The Break-even budget showed that 80 percent of the income was spent for food, housing, and clothing, and 20 percent for other items. There were no savings and no provision for family security. For the family of three, only $35 was spent for doctors' and dentists' bills and medical drugs and supplies; serious or prolonged illness would play havoc with such a budget. Ninety dollars a year were spent on vacations, excursions, movies, and other recreations; a movie for the family every two weeks would take half that sum. Nineteen dollars for reading would provide little besides a daily newspaper. Can we consider such purchases as luxuries? Yes, in that they are not absolutely necessary to life; no, if we consider life as including more than just existence.

The graph which follows uses in a different way the facts which have been previously presented for city families in 1944. Here the percentages are cumulative. Line 1 shows the percentage spent for food only; line 2 shows the percentage spent for food plus housing; line 3 shows

the percentage spent for the three necessities, food, plus housing, plus clothing; line 4 shows total expenditures. The highest income group, with an average of $7595, spent less than half its income on necessities (line 3) and about 20 percent on other items; over one-third of its income was left as savings. At the other extreme, the income group with an average income of only $776 had barely enough to pay for its food and housing and had to go into debt or spend previous savings to get

**PERCENT OF INCOME SPENT AND SAVED BY CITY FAMILIES—1944**




The percentage spent for food ranged from over 50% in low-income families to under 20% in high-income families. In the lowest-income family, income was sufficient to pay only for food and housing. Savings did not appear until incomes reached about $2,000. In the highest income group savings were about ⅓ of income. (Data from U.S. Dept. of Labor)

clothing and other items; more than half its income was spent on food. In the lower income groups the pressure of necessities upon income is constant and great.

### The Significance of Budget Studies

The facts presented cast light on standards of living, in terms of the goods consumed. They also suggest points to be considered in appraising and formulating economic policies. There is suggested, first of all, the notion that raising the standards of living of the lowest income groups may serve to increase the general productivity of the nation. If the pressure of basic needs in the low income levels is so great that little or nothing is left to maintain health, provide training and education,

and supply sufficient recreation, then production skills cannot be maintained and improved. As a result, the number of skilled, happy, and highly productive workers is kept down.

Secondly, we must recognize that as long as low incomes and poverty standards of living exist, community assistance, public or private, must be provided. Many such measures are provided in the form of relief payments, old-age and widows' pensions, unemployment-insurance payments, medical and dental clinics, and private charitable contributions. Free education, parks, playgrounds, concerts, libraries, and summer camps, supported largely by the taxes or voluntary contributions of those with higher incomes, have reduced the cash expenditures necessary for poor families to maintain themselves at a level permitting them to improve their earning opportunities.

A third lesson from budget studies is of special consequence in framing our tax laws. (See Lesson 78.) A sales tax on necessities bears most heavily on low income groups because they spend a larger proportion of their income for such goods. An income tax, on the other hand, bears more heavily on the high income groups. But it is easier for them to pay the taxes, since a larger percentage of their budget goes for luxuries and savings.

Fourth, an understanding of family expenditure patterns is of some service in predicting the effect of increases in family income upon business sales. If national income and family incomes increase, it may be anticipated that total expenditures for goods and services will increase. The percentages spent for food, clothing, housing, and other items will be different from what they were previously. The percentages devoted to recreation, books, radios, television, vacations, education, and similar items will tend to rise; industries producing goods and services for such uses can expect to gain most from raised family incomes and to be the first to feel the effects of a decline.

Finally, these facts fix attention on the importance, particularly in the lower income groups, of spending wisely in order to get full value. Where income is small and barely provides necessities, the dangers of waste are apparent. The pressure of needs upon income in the lower income groups explains the emphasis which has been placed upon consumer education among these families, and upon legislation to protect and assist them in better buying.

## Exercises and Summaries

I DICTIONARY OF ECONOMIC TERMS

| | | |
|---|---|---|
| budget | deficit | Engel's Laws |

II QUESTIONS AND PROBLEMS

1) Copy the table below and fill in the words "Increases" or "Decreases" or "Remains About the Same."

| | THE PERCENT SPENT FOR | | | | | |
|---|---|---|---|---|---|---|
| AS FAMILY INCOME | *Food* | *Housing* | *Clothing* | *Food, Housing, and Clothing* | *Other Items* | *Savings* |
| Rises | | | | | | |
| Falls | | | | | | |

2) In the graphs shown in this lesson, the lowest income groups spent more than total family income. How was this possible?
3) "The curse of the poor is their poverty." Explain this statement, showing its relationship to Engel's Laws.
4) Budget studies show that the percentage spent for food in rural areas and in agricultural countries is somewhat smaller than in cities. What may help to explain this?
5) Some studies of expenditure for clothing indicate that there is a rise in percent of income spent when the comfort level is reached, followed by a decline when the wealth standard is reached. How may social status and conspicuous consumption help to explain this?
6) For which of the following statements could Engel's Laws be used as an argument? Explain. (a) It is desirable to raise the wage levels of the lowest-paid workers. (b) Expansion of social services by government is desirable. (c) Private charitable organizations serve the whole community when they serve the needy. (d) Taxes should be in accordance with ability to pay regardless of who makes use of the projects paid for with tax money. (e) Sales taxes, to be fair, should not be levied on foods. (f) Rent control is of greatest value to low-income families.

III THINGS TO DO

1) Copy the headings in the budget on page 70 for the Break-even family and prepare a budget for your own family, or for an imaginary family in one of the income groups. How do the percentages spent for the various items compare with the average percentages for that income level as shown in the graphs on pages 73 and 75?
2) On page 74 there is a graph which shows the percentage spent for various items in different countries. Explain to the class how this may be used as a measure to compare standards of living in different countries.
3) Read and report on *Social Work and the Joneses*, Public Affairs Pamphlet No. 97 (1944), which describes the problems of low-income families from the viewpoint of the social worker.

4) Read and report on *How We Spend Our Money* (Public Affairs Pamphlet No. 18, Revised, 1941). Although the data are prewar, the detailed analysis of family budgets is still valid.
5) Read and report on Chapters 5 to 13 in *U. S. A.: Measure of a Nation* by Carskadon and Modley (Twentieth Century Fund, 1949).

## *LESSON* 11 THE AMERICAN STANDARD OF LIVING

### THE COST OF AN ADEQUATE STANDARD OF LIVING

The first step in attempting to form a picture of standards of living in the country as a whole is to define the various standards of living, as was done in Lesson 7. The second step is to measure the amount of income needed at each level. The third step is to count the number of families having the income needed for each standard.

To determine the cost of an adequate standard of living for a city family of four, the Bureau of Labor Statistics of the U.S. Department of Labor drew up an objective list of "necessary minimum" goods and services and then computed the cost of this budget in thirty-four large cities in 1946 and 1947. The budget was for a family occupying an apartment and consisting of father, mother, a boy aged thirteen, and a girl aged eight. The official description of this budget said

> When it is said that the budget is intended to cover the necessary minimum, "necessary" is to be given the common interpretation as including what will cover the conventional and social as well as the biological needs. It represents what men commonly expect to enjoy, feel that they have lost status and are experiencing privation if they cannot enjoy, and what they insist upon having. This is not a "subsistence" budget, nor is it a "luxury" budget; it is an attempt to describe and measure a modest but adequate standard of living.[1]

The dollar cost of this "adequate" budget in June, 1947, ranged from $3,458 in Washington, D.C., to $3,004 in New Orleans, Louisiana. Birmingham, Alabama, and Richmond, Virginia, occupied the middle positions in the list, with costs of $3,251 and $3,223, respectively. These costs represent averages. Some families could purchase the budget level for something less than average; others would have to spend something more. To deal in round numbers and to take the city in which the cost was lowest, we may use $3000 as the approximate minimum cost of

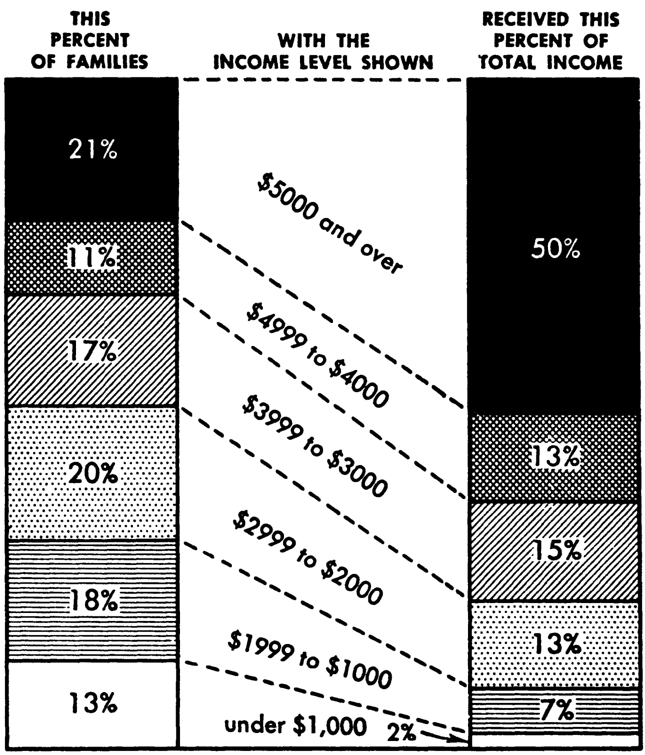
[1] "Workers' Budgets in the U.S., 1946 and 1947," U.S. Department of Labor, *Bureau of Labor Statistics Bulletin No. 927*, pp. 3–7.

this "modest but adequate" budget in American cities in 1947. Let us now see what proportion of American families had this income in 1947.

THE DISTRIBUTION OF FAMILY INCOMES

The chart below shows the way in which the national income was *distributed,* or shared, among families of two or more members in 1947.[2]

**DIVISION OF TOTAL 1947 INCOME AMONG FAMILIES BY INCOME LEVEL**




The bar at the left shows that 49% of families received $3,000 or over and 51% received under $3,000. The right bar shows the part of the total national income received by each group; the bottom 51% of families received only 22% of total income. (Data from *Federal Reserve Bulletin,* June, 1948)

The bar at the left shows the percent of the families receiving each income indicated in the middle section. For example, twenty-one percent of all families received $5000 or more, and thirteen percent under $1000. The bar at the right shows what percent of the total national

[2] *1948 Survey of Consumer Finances,* Part II, Board of Governors of the Federal Reserve System; Table 6, p. 7. There are many individuals not pooling income in

income was received by each group of families. Thus, the 21 percent earning $5000 or more received 50 percent, or half, of the national income; the other half of the income was divided among the 79 percent of the families earning less than $5000 a year. This illustrates the unequal distribution of the national income.

It will be noted that 51 percent of all families earned less than $3000. However, several factors tend to lower this figure of substandard families. First, we must make allowance for the fact that the incomes in the chart are for families of two or more, whereas the budget study is for a family of four. For a family of four the cost was estimated to be about one-half more than for a family of two. Second, as we have seen, income-in-kind is an important addition to cash income on the farm. Third, costs tend to be lower in places which are smaller than the thirty-four cities whose prices formed the basis for the estimate of budget cost. It would probably be a conservative estimate to state that approximately 25 percent, or about one-fourth, of all families were unable to buy the "currently adequate standard" of living with their own current incomes. In 1946, the Bureau of Labor Statistics estimated that "surveys of actual family incomes and expenditures indicate that more than three-fourths of city families are able to maintain the standards of living described."[3] This ties up pretty well with the statement in the previous lesson that 20 percent of city families in 1944 did not achieve the income sufficient to break even.

The year for which the data have been given, 1947, was one of high production, and national income was considerably more than in any previous year. The most comprehensive study of income distribution ever undertaken was made by the National Resources Committee for the year from July 1, 1935, to June 30, 1936, which was a comparatively bad year for business.[4]

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a family group and their incomes are not included in the chart. Such individual consumers tend to have lower average incomes than families of several members. Therefore, if the incomes of all "spending units" were given, the percent of lower incomes would be greater. The figures for all spending units in 1947, for purpose of comparison with those in the chart, were as follows: (Table 1, p. 3.)

| | |
|---|---|
| Incomes over $5000—14% | of all spending units |
| $4999 to 4000—10% | " " " " |
| 3999 to 3000—17% | " " " " |
| 2999 to 2000—23% | " " " " |
| 1999 to 1000—22% | " " " " |

[3] *The Gift of Freedom,* U.S. Department of Labor, Bureau of Labor Statistics, January 1949, p. 35.

[4] *Consumer Incomes in the United States,* National Resources Committee, Washington, 1938; Table 5, p. 22. The figures are for nonrelief families only. It was estimated that 15 percent of the total number of families were receiving relief.

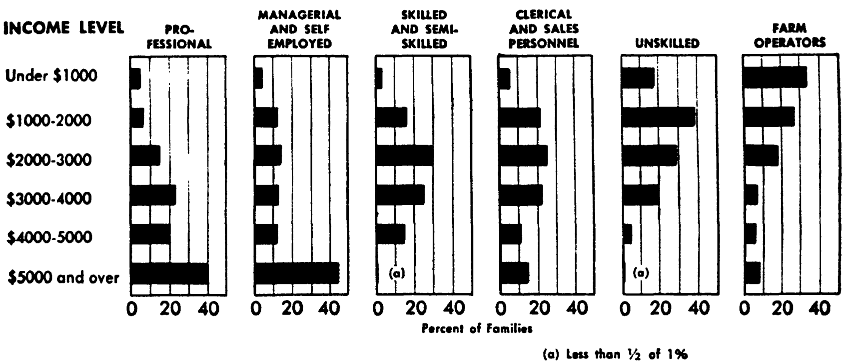
In that year, only 3.2 percent of families had incomes over $5000, compared to the 21 percent for 1947. On the other hand, 35.3 percent had less than $1000, compared to 13 percent for 1947; and 40.4 percent had incomes between $1000 and $2000, compared to 18 percent in 1947. A change in the total of national income tends to produce a definite change in the distribution. Experience has shown that when national production has increased, the percentage of families receiving lower money incomes has decreased.

The progress made since depression years may be noted by comparing 1947 with 1935–36. In 1935–36 the "necessary minimum" was only $1800 because of the lower cost of living. But about one-sixth of all families were on relief. Over two-thirds of the nonrelief families earned less than $1800. This group corresponded to the 20–25 percent who lived below the $3000 standard in 1947. When President Roosevelt said, in 1937, "I see one-third of a nation ill-housed, ill-clad, ill-nourished," he spoke rather conservatively of the standards that then prevailed.

### Comparing Standards of Living Among Different Groups

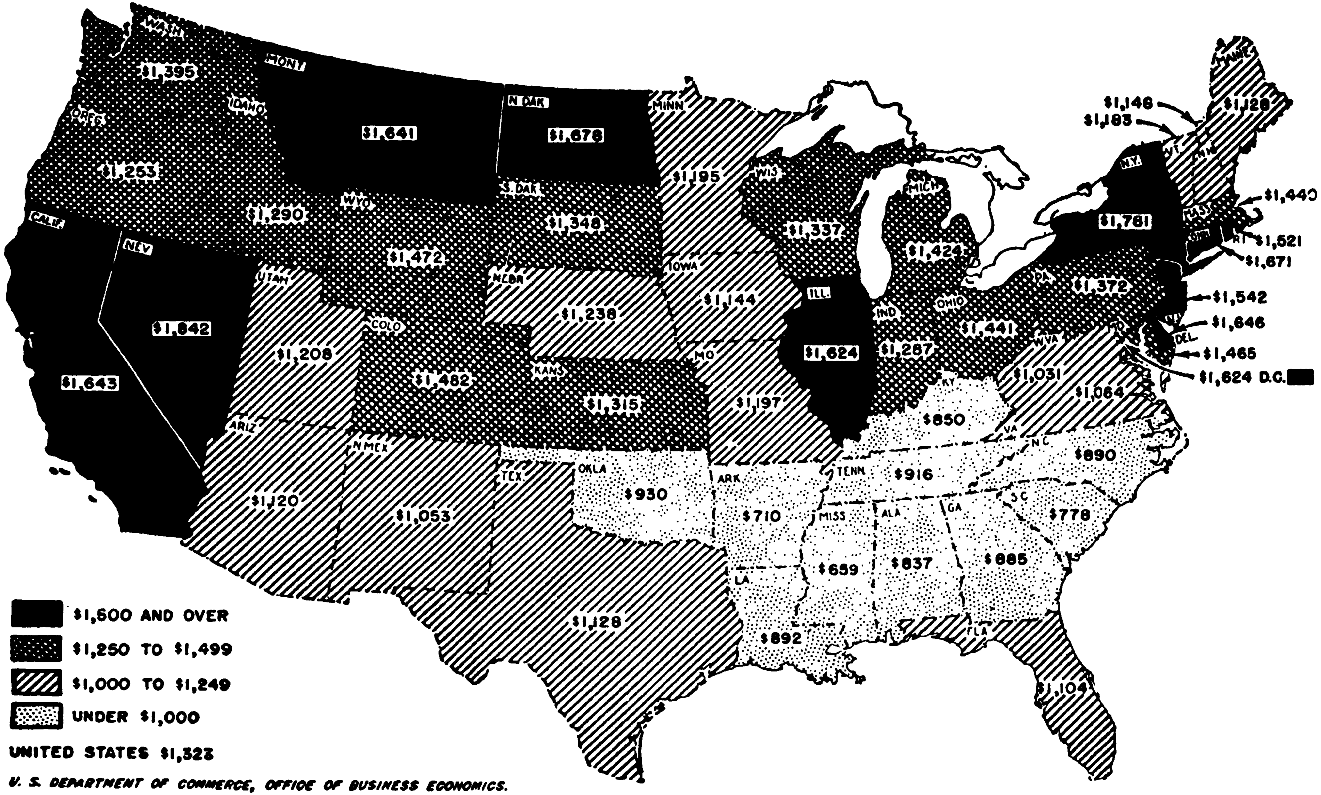
The chart which follows shows the distribution of income among families grouped according to occupation. Over 30 percent of farm

**INCOME DISTRIBUTION IN 1947 BY OCCUPATIONAL GROUP**




Each of the six bar charts shows the percentages of families receiving the stated income levels in one occupational group. Professional families and families of business managers and business owners ranked high, and unskilled workers and farmers low. (Data from Federal Reserve Board)

operators had less than $1000 in cash income, and about 60 percent of them earned less than $2000 in cash. The incomes of unskilled workers also were low, with almost 20 percent receiving less than $1000, and more than 50 percent receiving less than $2000. Professional workers




*Per-capita income payments to individuals in 1947*. The darker the shading, the higher the per-capita income. Ten of the 48 states ranked in the highest group. What was a possible reason for the high level of incomes in these states?

had the best incomes, with 40 percent receiving $5000 and over, and large percentages in the $3000–$5000 brackets.

Incomes varied from place to place in response to varied economic conditions. For the country as a whole, per-capita income (per person, and not per family) averaged $1323. Lowest per-capita incomes were in the southern states. The larger the population of the city, the greater the proportion of higher incomes. New York, California, and Illinois, states with varied industries and large cities, ranked high in per-capita income. Per-capita income by states is shown in the map opposite.

An important factor in comparing occupational and regional incomes is that some families, farmers particularly, receive a considerable amount of income-in-kind. The charts which have been presented therefore tend to underestimate these family incomes. The extent to which this is true may be gauged from the following facts pertaining to farm income in 1941:[5]

| a<br>*Average Money Income* | b<br>*Food Not Purchased* | c<br>*Housing Not Purchased* | d<br>*Money Value of Total Income* (a+b+c) | e<br>*Percent of Income-in-kind* $\left(\frac{b+c}{d}\right)$ |
|---|---|---|---|---|
| $ 403 | $159 | $132 | $ 694 | 41.9 |
| 833 | 177 | 188 | 1198 | 30.5 |
| 1591 | 189 | 224 | 2004 | 20.6 |

However, even when we take account of the fact that the cash income of the farmer gives an incomplete picture of his total income, there is still no doubt that there are more farm families in the lower income groups than in the high ones.

### Comparing Standards of Living Among Different Nations

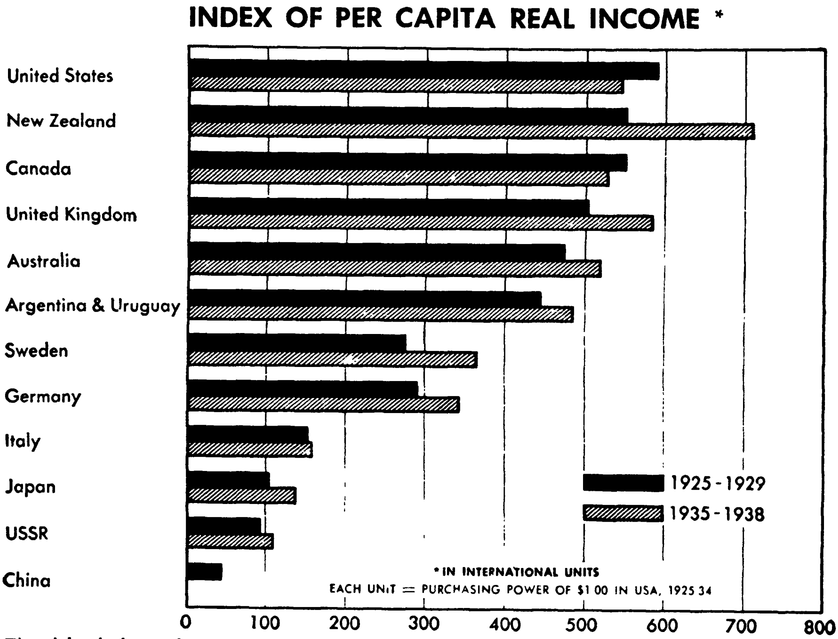
Although the United States does have many families on the poverty and subsistence levels, particularly when depression strikes the nation, it has reason to congratulate itself on having very high standards compared with those of other countries. Colin Clark, an economist, compared standards of living in 1940 and came to the conclusion that one-tenth of the people of the world lived in countries of relative abundance, six-tenths lived in countries of extreme poverty, and three-tenths were in between.[6] The United States was at the top of the fortunate tenth.

One measure of relative standards is the real income of the people. A study made by this same author, on the basis of real per-capita in-

[5] *How Families Use Their Incomes,* U.S. Department of Agriculture, Miscellaneous Publication No. 653, Table 5, p. 54.

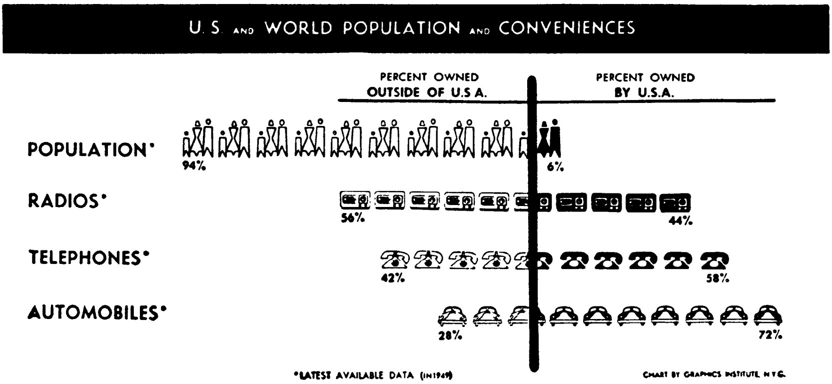
[6] Colin Clark, *The Economics of 1960,* The Macmillan Company, 1942.

come for the relatively prosperous period from 1925 to 1929 and for the relatively depressed period from 1935 to 1938, showed that for the first period the United States led the list, with New Zealand, Canada and the United Kingdom following immediately after. For the second period the United States was slightly behind New Zealand and the United Kingdom. In both periods Germany, Italy, Japan, the USSR, and China ranked very low.




The black bar shows per-capita real income for a relatively prosperous period in the United States; the lighter bar for a period that was somewhat depressed. In both periods the United States ranked high in this index of living standards. (Data from Clark, *The Economics of 1960*)

By comparing the ownership or consumption of goods of a luxury nature, an indirect measure of comparative standards of living is obtained. It is assumed that the more there is consumed or owned of a particular luxury good, the higher is the general consumption and the higher is the standard of living. It must be remembered, however, that sometimes a particularly high consumption of a commodity is more an index of tastes and local customs than it is of standards of living. The chart at the top of page 85 shows that the United States, with 6 percent of the world population in 1949, owned much larger percentages of the world's radios, telephones, and automobiles. Whether such mechanical goods are used as an index, or sugar consumption, or the amount of mail sent, the United States ranks at the top or near the top.




The high standard of living in the United States is shown by the proportion of luxury items owned. Six percent of the world's population, living in the United States in 1949, owned 44% of the world's radios, 72% of the automobiles, and 58% of the telephones.

Another method frequently used to compare standards of living is to compare the number of hours of work it takes, at wages and prices existing in different countries, to buy a given quantity of goods. The chart below shows this for a half-dozen countries for the years just prior to the war.

## PAID HOURS OF WORK NEEDED TO BUY

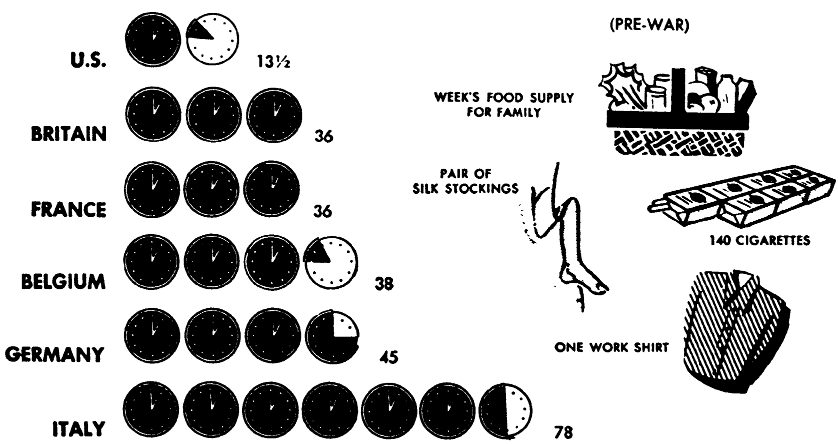



Chart by GRAPHICS INSTITUTE, N. Y.

It took about 13½ hours of work, in the United States before the war, to buy the goods pictured. It took almost three times as much labor in Britain, and about six times as much in the lowest country shown.

The war widened the gap between American standards of living and those of other countries. Billions in money and goods poured from this

country to aid other nations to recuperate after the war, partly because we have come to recognize that just as urban and rural standards of living depend upon each other, standards of living all over the world have a degree of interdependence. We have seen that there is room for improvement in our standards of living, and that standards are destroyed by depression and the reduction of national income. To an extent, at least, the maintenance of our higher levels of living and their further improvement depend upon the eradication of the low standards which prevail in most of the rest of the world.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

adequate budget — distribution of income

II QUESTIONS AND PROBLEMS

1) Explain how the "adequate budget" discussed in this lesson was arrived at.
2) Would President Roosevelt's statement that about "one third of a nation" was "ill-nourished, ill-housed, and ill-clothed" be correct for the year 1947? Give evidence for your answer.
3) Foreign critics of the United States in 1946 and 1947 were issuing propaganda broadcasts stating that workers in the United States were generally living in misery. Which facts could you present to prove the untruth of this statement?
4) Explain what may be reasons for each of the following: (a) There are more high-income families in large cities than in smaller places. (b) There is a difference in average income between farm operators and businessmen. (c) The Pacific States have a higher per-capita income than the Southern States. (d) Income is not equally distributed among the nation's families. (e) It took a larger income to buy a health and decency standard in 1947 than in 1935.

III THINGS TO DO

1) Read (a) *The Gift of Freedom,* a pamphlet prepared by the Bureau of Labor Statistics, United States Department of Labor. A documented account of levels of wages, living standards, and consumption in the United States. It is available at low cost from the Superintendent of Documents, Government Printing Office, Washington, D.C. (b) *The South's Place in the Nation* (Public Affairs Pamphlet No. 6, Revised, 1938). A prewar analysis of the social and economic problems of the South. (c) *Our Material Progress,* one of the pamphlets in the *You and Industry* series published by the National Association of Manufacturers. It stresses the superiority of American

standards of living over those in foreign countries. (d) *The Road to Survival* by William Vogt (Sloane). This book contains some up-to-date comparisons of standards of living. (e) *U. S. A.: Measure of a Nation,* Chapter 4. Simple treatment and excellent graphics.

2) Consult your library for data to bring the tables and charts on income distribution up to date. Write to the Board of Governors of the Federal Reserve System for the most recent report on income distribution. Report on the changes that have taken place since 1947.

# *LESSON* 12 HOUSING AND STANDARDS OF LIVING

## THE IMPORTANCE OF HOUSING

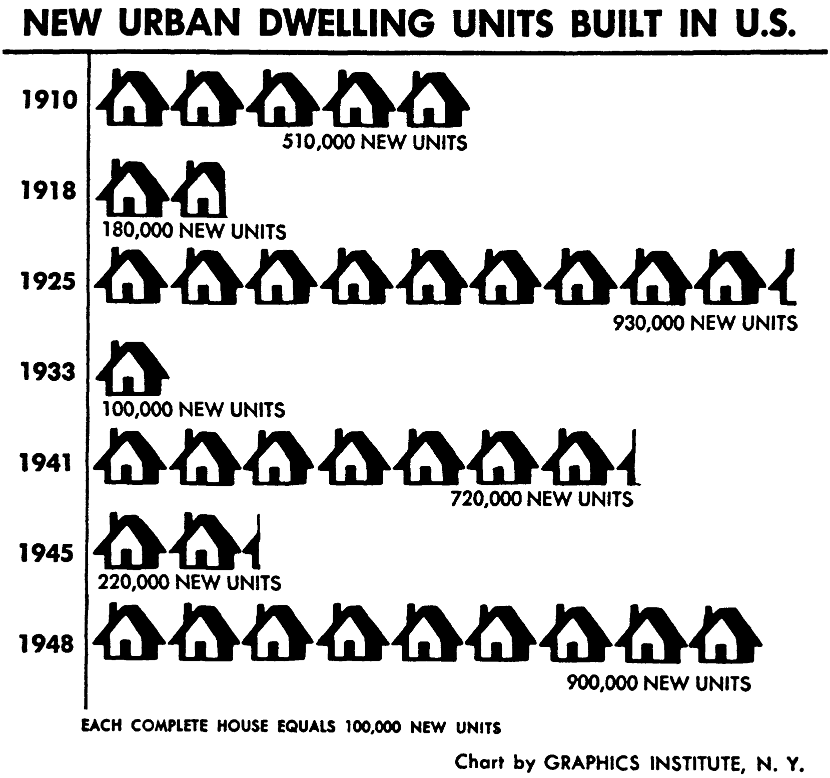
Probably more than any other item in the budget, a family's house or apartment reflects its standard of living. The visitor to this country will find it hard to form an idea of the typical diet of a particular American family; he may do better in judging the clothing budget; but the kinds of dwellings he sees will do most to create definite impressions. The fashionable apartment houses and suburban dwellings of well-to-do city dwellers contrast sharply with the crowded, run-down tenements of the slum section; the shack of the *sharecropper* (see p. 412) stands in similar contrast to the neatly painted farmhouse of the well-to-do farmer.

Housing, second only to food as an item of expense in most budgets, accounts for approximately 25 percent of all expenditures of medium-income families. Most families are tenants, and the cash outlay for rent is a fixed one which must be met at the beginning of each rental period. Clothing and luxury expenditures may be postponed, but rent must be paid continuously. For the homeowner, whose housing costs consist of taxes, interest, and repair and maintenance, it is an important form of savings as well.

Poor housing is a reflection of low standards of living; on the other hand, a low rate of building construction is one cause of low incomes. Nearly two million workers, including some of the most highly skilled, depend directly upon construction activity for their incomes. Other millions depend upon building activity indirectly, for they furnish lumber, steel, glass, paint and other building materials, as well as plumbing, heating, electrical supplies and ranges, refrigerators, and furnishings. Study of the graph on page 88 reveals that 1925 and 1941, both years of relatively high production and national income, were years in which many new residential units were built: in 1933, the year of the

most depressed economic activity and low national income, new residential construction almost disappeared.

In a previous lesson it was explained that freedom of choice for consumers was one of our basic institutions. In buying housing, however, some consumers, although they may have the necessary money, do not have full freedom of choice; the problem is complicated by the exist-




The peak of building was reached during the boom of the 1920's. The small amount of building in the 1930's was both a symptom and a cause of the depression. Building activity was curtailed also during the war years. (Data from National Industrial Conference Board)

ence of religious or racial discrimination. Buyers of land or houses are sometimes asked to sign a *restrictive covenant,* by which is meant a clause agreeing not to resell the property to members of specified races or religions. The barred groups are therefore limited in their choice of dwelling places and are sometimes forced to live in the older sections of the city, not infrequently a slum or near-slum area. A Supreme Court decision in 1948, which held that such restrictive covenants could not

be enforced in the federal courts, may lead to the gradual disappearance of this practice.

## Housing Conditions

A house is a durable good; it wears out gradually, or *depreciates,* but is almost never completely used up, unless, at great expense, it is wrecked. Even if it is abandoned and closed down, tax expense, at least, continues. Thus houses continue to be used even though they are old, lacking in up-to-date architectural design, and needing modern conveniences. In April, 1940, as shown by the table which follows, the average age of city dwelling units was about 25 years; farm dwellings were somewhat older; and dwellings in rural nonfarm areas were somewhat newer.

Age of American Homes—April 1, 1940[1]

| *Age in Years* | *Urban* | *Rural Nonfarm* | *Farm* |
|---|---|---|---|
| Over 50 years | 12 percent | 12 percent | 17 percent |
| 40 to 50 " | 11 " | 8 " | 10 " |
| 30 to 40 " | 18 " | 14 " | 18 " |
| 20 to 30 " | 19 " | 16 " | 19 " |
| 10 to 20 " | 29 " | 24 " | 18 " |
| 0 to 10 " | 11 " | 26 " | 18 " |

The chart on the next page shows the percent of homes lacking particular conveniences in 1945.

About three-fifths of city homes lacked central heating; almost one-fifth did not have private baths; about half of our farms were without electric light and many did not yet have water piped into the home. Although war shortages hindered them, some improvements were installed between 1945 and 1947. In 1948 almost a million new urban dwelling units were constructed. An effect of increased income, as we have seen, is to spend more on housing, to increase the pressure to move to a better neighborhood, to reduce crowding, and to acquire new conveniences. Despite these advances, however, dwellings and improvements have not been added rapidly enough to meet the demand. A survey by the Census Bureau in 1948 reported that of the 42 million dwellings in the country, one-third were substandard and three million families were living doubled-up because of the housing shortage.

## Problems of the Building Industry

Housing construction lags behind manufacturing industry in the *mass-production* techniques that have made American industry famous.

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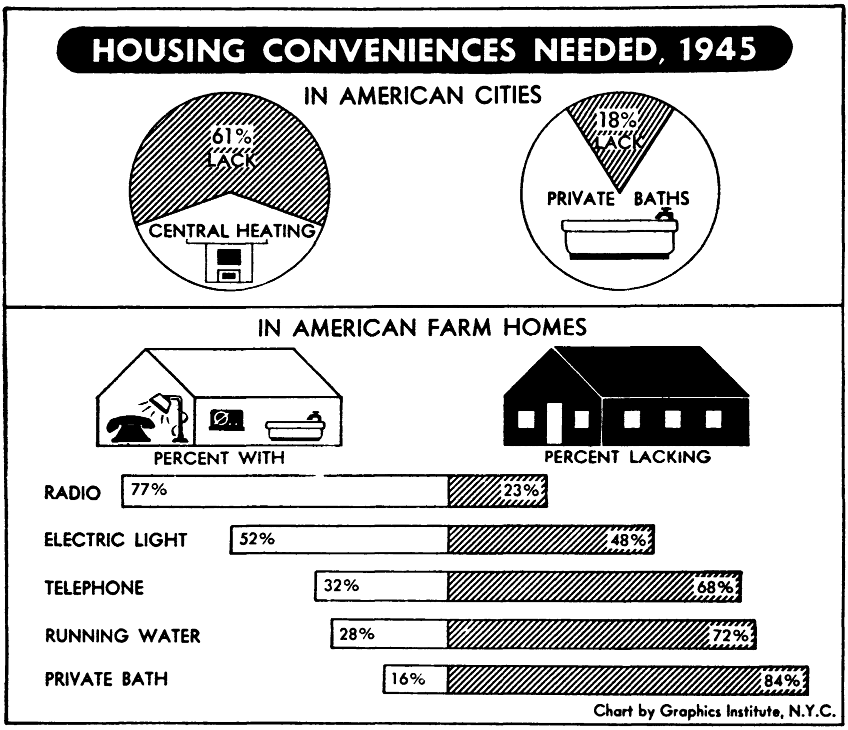
[1] Department of Commerce as reported in *Information Please Almanac 1949,* p. 316. "Rural nonfarm" includes villages and towns with less than 2500 population.

Mass production means the production of standardized, machine-made products in large quantity, which makes possible a reduction in the average cost per item. Home building is still largely done by assembling many parts, in some cases as many as thirty thousand for one house, and by using hand tools. Prefabrication of homes in large parts, which would require relatively simple assembly on the site, is still an




The chart reveals that in 1945 many city homes were lacking in some essential conveniences. The lower section shows that farm homes were particularly lacking in modern conveniences. The disappearance of war-caused shortages made possible some improvements.

infant industry. Costs of home building have not been affected by the downward pressure of mass production to the same degree as have other durable products such as automobiles.

The construction business is not so readily organized for production on a large-scale basis as is the automobile industry. The contracting business consists mainly of small firms; in 1938 more than four-fifths of all construction firms employed fewer than ten employees, and only one percent employed one hundred or more. Contractors often parcel out the work among many subcontractors; some are in the business on a

part-time basis; materials and supplies are bought from hundreds of small supply houses. Such business organization is hardly likely to encourage large scale, mass-production methods.

Another obstacle to mass production is the resistance of consumers accustomed to individuality. It remains to be seen whether American ingenuity will be fully equal to the task of producing homes with artistic variety on a mass-production basis.

Costs of land, materials, and labor tend to be high. Particularly in large cities is the high cost of land a deterring factor in putting up low-cost dwellings. Small contractors must compete for supplies and materials against builders of commercial buildings, bridges, roads, and public projects. Buying is in small lots and prices are high to buyers. It is claimed that both manufacturers of building supplies and the building-trades unions have worked to keep costs at artificially high levels. It is charged that manufacturers have agreed among themselves to fix prices at levels which will produce high profits and prevent the business from losing through competition. Trade unions have been blamed for refusal to install any appliances or materials not produced by union labor, for organizing to keep hourly rates at very high levels, and for refusing to use labor-saving devices. To this the unions respond by pointing out the extremely seasonal nature of most building and therefore the need for high wages while there is work; also that the building trades include highly skilled workers, who should be well paid. Labor cost, they argue, makes up only about 25 percent of the final cost of the average home; a one-fifth reduction in wages would reduce the cost of a $5000 home by only $250. Suppliers of materials explain that materials make up only 40 percent of final cost, and point out that on a $5000 house a one-fifth reduction in price of materials would save only $400 in cost.

Building is regulated by *building codes*. These are laws of state and local governments established for the protection of the public against the dangers of fire, building collapse, and unhealthful conditions. They specify the kinds of materials that may or may not be used in structures of varying size and purpose, and establish engineering standards as to electrical, plumbing, and heating systems. Building codes vary greatly from community to community. This variety in itself makes mass production of building supplies less possible. Many laws are out of date in that they do not permit new materials, do not provide for easy use of prefabricated parts, but make for continued use of traditional, often high-cost and scarce materials.

The construction of new housing is complicated by the problem of how best to locate new housing close to the centers of trade and business or within easy reach of them. This frequently involves the building

of new means of transportation, water and sewerage systems, schools, and other facilities which require long-range planning.

The cost of housing is further increased by the numerous legal requirements, which make it advisable to employ the services of brokers, lawyers, and title insurance companies.

### Public Housing

In recent years, the government has acted to ease the housing problem by building housing units out of public funds. During the depression years of the thirties, there was much unemployment, and incomes and standards of living were low. All industry was marking time, and the industries serving construction, such as steel, cement, and lumber, were working at the lowest levels of all. In undertaking the building and operating of housing projects the aim of the government was threefold: (1) to stimulate the industries serving the building industry so that these in turn would stimulate others; (2) to provide employment and increase consumer incomes; and (3) to improve living standards and start the job of eradicating slum areas.

Housing paid for out of public funds, and constructed and managed by a government agency (federal, state, or local), is what is meant by *public housing.* In 1937 a long-range federal program was launched with the creation of the United States Housing Authority (USHA). An *authority* is an agency of the government organized by legislation to carry on a business undertaking of the government. The USHA has financed building operations by local or state governments. A city wishing to construct low-cost public housing could borrow from the USHA for a term up to 60 years, at a low rate of interest, usually about 3 percent. One condition of each loan was that for each new unit built, a slum dwelling had to be destroyed or repaired. In addition to loans, the USHA could grant sums of money, or subsidies, to bring maintenance costs down and make it possible for rent to be lower than cost. The Federal Housing Administration has also encouraged the building of new homes, as well as the improvement of old ones. It guarantees loans made by banks for the construction or repair of housing.

During the war, except for the erection of a considerable number of emergency quarters to house war workers, new building was suspended. Rent controls were instituted early in the war to prevent the housing shortage from causing rents to zoom upwards; these controls persisted longer than any other type of price control.

The war's end brought a clamor for the government to do something about the housing shortage. Many advocated a large program of public housing; others opposed it with vigor, expressing the fear that the increased entry of government into building might be a blow to our tra-

ditional system of private enterprise. They argued that private builders could do the job and, in fact, were doing it. They stated that the function of the government was to remove the restrictions placed by industry and labor upon lowered costs and to provide liberal credit terms to encourage private building. They argued that public housing would create a government demand for materials with which private operators could not compete, and which therefore would curtail the amount of private building.

Those who favored public housing argued that only the government could provide sufficient capital to operate on the scale necessary for economy. They were of the opinion that private building, extensive as it was, served mainly the middle and upper income groups, and that government subsidy was necessary to provide desirable housing for poorer families. Otherwise. they claimed, the lower income groups could never afford to buy or rent new, up-to-date housing and would merely occupy the vacated premises of the more fortunate who could afford the new. They answered the charges that the cost would be great and taxes would rise, by pointing out that the projects were in many cases practically self-supporting, and that any increased tax cost would be balanced by savings in fire, police, and health costs of the communities where slums were replaced by new housing.

In 1949 and in 1950, the federal government passed new laws to expand federal loans for private and public housing construction. These laws stand as our most current effort to attack the problem of low standards of living by an organized drive under government leadership. There has been much controversy, however, as to the adequacy of these measures as devices to eradicate slums and to improve the level of housing.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| authority | mass production |
| building codes | public housing |
| | restrictive covenant |

### II Questions and Problems

1) Define or identify each of the following, showing its relation to the problem of housing: (a) prefabrication, (b) urban dwelling unit, (c) mass production, (d) FHA, (e) USHA, (f) housing authority.
2) Explain why the improvement of housing standards involves (a) economic problems and (b) social problems.

3) "Low incomes and bad business conditions mean poor housing." "Poor housing means low incomes and bad business conditions." Explain how both statements can be true.
4) (a) How does the fact that a home is a durable commodity complicate the problem of providing good, modern housing for all? (b) What factors help to explain the failure of the home-construction industry to use mass-production methods?
5) List and explain at least three explanations for high costs in home construction.
6) List and explain briefly three methods by which federal, state, and local governments have tried to meet the problem of housing.
7) In parallel columns list the arguments for and against more public housing.

## III Things To Do

1) Have a debate or forum discussion in class. The following topics are suggested: (a) Should the government provide housing at below-cost rentals to the poor? (b) Should public housing include housing for middle-income families? (c) Should rent control be made a permanent feature of our economic system? (d) How can we best eliminate city slums? (e) How can we prevent discriminatory practices in housing?
2) Make a report on housing conditions and housing projects in your community.
3) Write a report on public housing projects in European countries.
4) Bring the charts on pages 88 and 90 up to date. Consult the library for data.
5) Interview your local real-estate broker. Report to the class what he thinks about (a) public housing or (b) rent control.
6) Read and report on the following: *Housing for Tomorrow* (Public Affairs Pamphlet No. 96, 1945), which deals with the economic and social aspects of housing; *Homes to Live In* (Public Affairs Pamphlet No. 66, 1942), which suggests home improvement measures; *U. S. A.: Measure of a Nation*, Chapter 15, "Toward Finer Cities."
7) Report to the class on the housing acts of recent years.

# *UNIT 4*

## PROBLEMS OF THE CONSUMER

*13* THE BEWILDERED CONSUMER
*14* CONSUMER CREDIT
*15* THE CONSUMER AND SAVINGS
*16* LIFE INSURANCE
*17* EDUCATING THE CONSUMER
*18* STANDARDS AND LABELS
*19* CHECKING HARMFUL PRACTICES
*20* CONSUMERS' COÖPERATIVES

# *LESSON* 13 THE BEWILDERED CONSUMER

## The Origin of the Consumer Problem

Our great-great-great grandparents did not face the problems that we face today as consumers. In the early nineteenth century each community was largely self-sufficient. Living quarters, food, clothing, furniture, and many other things were, for the most part, homemade, and within each family a variety of skills were to be found. People were accustomed to growing crops, preserving foods, raising and slaughtering animals, tanning leather, spinning and weaving cotton and wool, cooking and baking, building houses and barns, making furniture, and fitting and repairing plumbing. Because of these experiences they were bound to know a great deal more than we do about materials and about the structure and durability of goods.

With the shifting of production from the home to the factory, the skill of the individual as a consumer declined. Each decade brought new goods and services into the lives of the people, but the people knew less and less about these goods and services. Few of us today can make a pocketbook, build a bookcase, sew a dress, or pickle meats. We know little about cloth, leather, tools and machines, and building materials.

This loss of knowledge about goods is unfortunate because we use so many more things than our forefathers did, and we buy practically everything ready-made. The less we know about goods, the more we have to rely upon the honesty and integrity of producers and distributors.

The producers and the sellers, however, have their own problems. They are now part of a vast system of production and sale of goods, in which profit depends mainly upon a large volume of business. The businessman can no longer wait for customers to come to him; he must get the customers' orders before a competitor does. Skill in selling is as important as skill in production.

Advertisements in newspapers and magazines, displays in store windows, and door-to-door canvassing are the chief types of appeal to consumers' pocketbooks. Styles are changed frequently in clothing, automobiles, radios, and many other things, in order to persuade people to discard goods that would otherwise be useful for much longer periods of time. The economical housewife and her husband are torn between the desire to make things last as long as possible and the desire to be up-to-date and to keep up with the Joneses.

One would imagine that, with businessmen fighting for the consumer's favor, the consumer would always get top-quality goods at rock-bottom prices. Mass production and intensive competition have, over the past few generations, brought us a vast quantity and variety of goods and services at low cost. Yet there is reason to believe that part of the benefit of mass production and distribution has been lost through the confusion into which the consumer has been thrown by modern methods of buying and selling.

### Buying Goods by Specification

When the United States Army buys overcoats, it proceeds in a scientific way. First, the qualities needed in an Army overcoat—principally, warmth and durability—are analyzed by the Army. Tests are made by the Army, or by the National Bureau of Standards in the Department of Commerce, of different kinds of cloth, buttons, thread, linings, pockets, sleeves, and collars. As a result of this analysis and testing, the Army draws up exact *specifications* for the coat, that is, a detailed description of style, materials, dimensions, and methods of production.

The Army then invites coat manufacturers throughout the country to submit *bids* for the sale of a certain number of overcoats made according to the specifications. The bid tells the price at which the manufacturer is willing to sell the overcoats to the government. On the designated day the bids are opened and examined. The contract is awarded to the lowest bidder. The contract provides, of course, that the manufacturer, in order to get his money, must deliver to the Army coats made exactly according to the specifications.

Because government agencies and large business firms can secure expert advice, they know just what they want and do not have to rely upon information from friends, advertisements, or salesmen. Instead of asking questions of the seller, they tell the seller what they expect, and they have some knowledge as to how much the article ought to cost. Since they are buying on a large scale, they have a good chance of getting the lowest possible prices from the sellers.

### Buying Goods by Brand Names

The average consumer cannot buy goods in this scientific manner, because he makes his purchases in small quantities. Except for farm families, today's consumers live in smaller apartments and houses than formerly, and have no room to store foods and materials for future use. The improvement of communication and transportation makes frequent shopping easy, so that there is no need for buying large amounts at a time. This change in buying habits has increased the convenience of our way of living, but it has created some problems for us as consumers.

We have become accustomed to buying many goods in packages—cans, jars, bottles, and boxes. Each package has a *brand name,* which identifies the product as having been made by a certain manufacturer. The brand name is registered, in the same way that an invention is patented, so that no other firm may use it. Partly because of advertising, people get into the habit of asking for particular brands. Their feeling that certain brands are dependable makes it unnecessary for them to examine goods thoroughly before buying them. Instead of asking storekeepers for any cereal, coffee, or milk of magnesia, they select these articles by brand name alone. The brand name has come to stand for the product itself.

Even in the case of goods which we do not buy from day to day—automobiles, radios, furniture, linens—consumers are inclined to choose products mainly through brand names and because of the exterior appearance of the article. We read advertisements, listen to radio commercials, consult our friends, and as a result of the repetition of certain brand names, we begin to feel that these brands are superior. Once the loyalty to a brand has been established, it takes pressure to switch us to another.

### Variety and Confusion

As a result of the competition among sellers, the consumer is confronted with a large variety of brands. In 1938, for example, an investigation[1] in Milwaukee showed that throughout the city there could be found

| | | | |
|---|---|---|---|
| 31 | brands | of | canned milk |
| 142 | " | " | coffee |
| 95 | " | " | tomato juice |
| 177 | " | " | butter |
| 109 | " | " | peanut butter |
| 235 | " | " | cigars |
| 188 | " | " | safety razors |
| 134 | " | " | washing machines |

The consumer's confusion is increased by the large variety in sizes of containers. Businessmen have experimented with many sizes and shapes of containers so that their packages will have the greatest amount of sales appeal. In 1941, investigation showed that 258 different can sizes were being stocked on grocers' shelves throughout the country. A conspicuous example was found in the cans used for tomato juice, which could be bought in at least 17 different sizes.

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[1] "Problems of the Consumer," *Hearings of the Temporary National Economic Committee,* Part 8.

Such variety would seem to be a consumer's paradise. But this is not necessarily so, for the consumer has to make a choice.

Since today's consumer is unaccustomed to handling raw materials or to making things, he finds it hard to judge the quality of materials or workmanship. He is so impressed by the streamlined body, the plastic dashboard with chromium gadgets, and the bright upholstery of an automobile, that he hardly remembers that he is buying a motor and four wheels. When he buys a radio he may be told more about its beauty as furniture than about its operating efficiency. The same perfume which, in a plain bottle, sells for 25 or 50 cents, may, in a fancy bottle, be sold for much more.

RESULTS OF A STUDY OF CANNED FRUITS AND VEGETABLES, JUNE 1941*

| *Commodity* | *Size of Can* | *Brand* | *Grade in Laboratory Test* | *Retail Price* |
|---|---|---|---|---|
| APRICOTS | #2½ | 1 | B | .19 |
| | | 2 | B | .38 |
| | | 1 | A | .19 |
| FRUIT COCKTAIL | #2½ | 2 | Off-grade | .29 |
| | | 3 | Off-grade | .25 |
| | | 4 | A | .35 |
| | | 1 | A | .25 |
| ASPARAGUS | #2 | 4 | C | .37 |
| | | 5 | A | .45 |
| | | 6 | C | .39 |
| CREAMED CORN | #2 | 1 | A | .09½ |
| | | 2 | B | .15 |
| | | 4 | C | .12 |
| | | 7 | A | .18 |

* *Journal of Home Economics*, October, 1941. The grades used in the test were government grades. "A" represents highest quality, then "B," "C," and "Off-grade."

If the consumer tries to be scientific, he usually becomes baffled. The more friends he asks, the greater the differences of opinion he will get as to the best buy. From advertisements he gets mainly slogans, artistic designs, testimonials of famous people, and so-called "secret" formulas —they do not contain enough definite information to help him get the most value for his money. If he asks the salesman in a store, he may not learn what he needs to know; after all, a salesman is not employed mainly to be a consumer's guide.

For the small items we buy frequently—groceries, cosmetics, etc.— the trial-and-error method can be used with little damage. We try dif-

ferent brands until we find the one we like best or the best one we can afford. But when buying semidurable and durable goods—clothing, furniture, automobiles—the trial-and-error method becomes impractical. We must rely on information learned from friends, salesmen, and advertisements. To a large extent we buy according to price. We pay as much as we can afford, and assume that the higher the price, the better the article is.

Yet frequent tests have shown that such an assumption is not always valid. In many cases, brands selling at about the same price differ widely in quality, whereas brands selling at higher prices are sometimes little, if any, better than lower-priced competitors. Sometimes the difference between a higher-priced and a lower-priced brand is a factor like appearance, packaging, or an unimportant ingredient, so that there is no real difference in usefulness to the consumer.

The results of a laboratory test of price and quality are shown in the table opposite. Note that some cans of lower-grade products were being sold at higher prices than cans of higher-grade products.

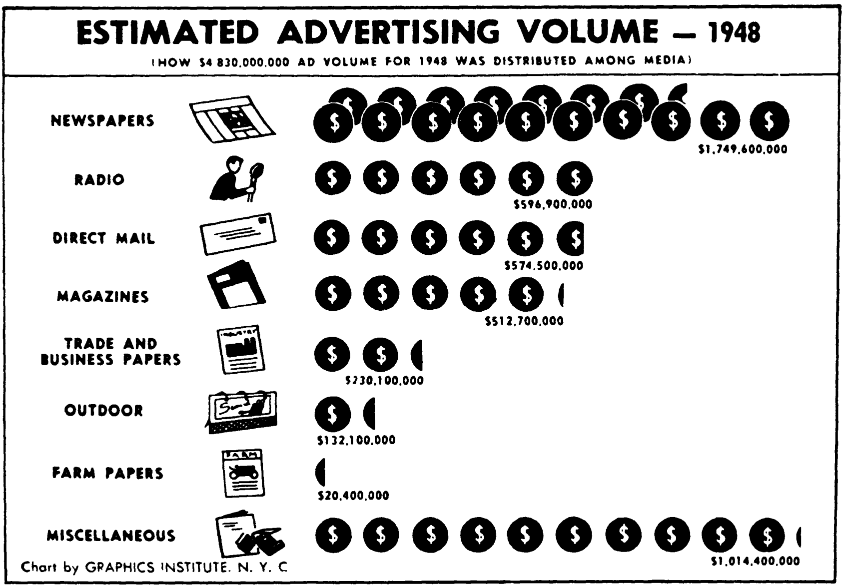
### The Controversy over Advertising

Because our buying of goods and services is influenced so much by advertising, there has been much argument as to the value of advertising to the community. Some people argue that advertising is a social waste and adds to the cost of goods. They say that if advertising were eliminated, the saving could be passed on to the consumer in the form of lower prices. Without advertising, in their opinion, businessmen would compete through giving the public lower prices and higher quality, instead of through brand names and slogans. The health of the nation would also be protected against excessive use of food and drug preparations bought as the result of advertising and used without the advice of doctors.

Others insist that advertising reduces, rather than increases, the cost of goods and services. Advertising, with its power to produce a mass demand for goods, is as much a part of the system of mass production as are machines. Proof of the price-lowering effect of advertising is supplied by the increased use of automobiles, radios, electrical appliances, and many other products during the 1920's and 1930's. Moreover, the defenders of advertising point out, advertising has created tens of thousands of jobs in newspapers, magazines, radio, printing, paper, and in many other industries, as well as in the advertising industry itself. It has made it possible for the American people to buy newspapers and magazines at low rates and to get the best of radio entertainment without charge. By improving buying and living habits, it has lifted the American standard of living. At the same time that it has sold soap and

beans and shampoos, it has taught people about hygiene, safety, travel, books, plays, and other aspects of our civilization.

As we listen to these arguments, we realize that advertising is an important influence in American life. It is more than a matter of dollars and cents. Advertisers support our newspapers, magazines, and radio stations. Advertising can thus be more than a device for selling goods; it can also be a means of molding public opinion. In recent years, political organizations, trade unions, and business organizations have used




Almost five billion dollars were spent for advertising in 1948. Over one-third of the total was spent for advertising in newspapers and almost one-sixth for advertising in magazines, trade papers, and farm papers.

printed advertisements and radio broadcasts to present their ideas to the public. One of the problems facing American democracy is how to guard freedom of the press and radio against abuse by special groups.

### The Consumer: Ruler or Ruled?

We are told that the consumer is really a voter in the market place. Each dollar he spends is a ballot with which he votes for one product as against another. The business done day by day in the stores of the country has the effect of an election in which consumers determine which businessmen shall succeed and which shall fail.

It is easy to show that the consumer exerts a considerable influence over the actions of the business world. When women decided, during

the 1920's, that they wanted to wear simpler clothing, the clothing manufacturers had to produce shorter skirts and dresses with fewer trimmings. In the 1930's the attempt to sell ostrich-feather hats was a failure, for American women did not like them.

On the other hand, the consumer is constantly under pressure from those who want to sell him goods and services. From season to season he has to adapt himself to style changes in clothing, jewelry, automobiles, and radios.

## Exercises and Activities

I Dictionary of Economic Terms

bid brand name specifications

II Questions and Problems

1) (a) Explain how the consumer has benefited from the industrial revolution. (b) What problems were created for the consumer by the industrial revolution?
2) (a) How have shopping methods changed during the 20th century? (b) Show how the variety of brands and sizes has both benefited and hurt the consumer.
3) Explain why you agree or disagree with the following statement (if possible use your own shopping experiences to illustrate your points): "The trial-and-error plan which your mothers and grandmothers used is still a reliable guide, but best of all is the brand name on any product whose manufacturer has spent large sums of money on laboratories to produce the best article that can be manufactured in his line." (From *Consumer Questions Answered Here,* compiled by Consumer Division, Crowell-Collier Publishing Company, New York.)
4) List the arguments on both sides of each of the following questions: (a) Does advertising raise or lower the cost of living? (b) Does advertising increase competition or monopoly? (c) Does advertising educate or deceive the public?
5) The United States Supreme Court has ruled as follows: "Advertisements as a whole may be completely misleading, although every sentence separately considered is literally true. This may be because things are omitted which should be said, or because advertisements are composed or purposely printed in such a way as to mislead. . . . Questions of fraud may be determined in the light of the effect advertisements would most probably produce on ordinary minds. . . . 'Laws are made to protect the trusting as well as the suspicious.'" Do you think the standard set up by the Supreme Court is reasonable? Defend your answer.
6) The charge is made that advertising threatens the freedom of the

American press and radio. (a) Explain what is meant by this charge. (b) What evidence can you find for or against this charge?

III Things To Do

1) Make a list of your activities for one day, and show to what extent these activities have been influenced by advertising.
2) Paste into your notebook advertisements clipped from newspapers and magazines, illustrating the following kinds of advertising appeals: (a) slogans or "glamorized terms," (b) desire for social approval, (c) fear of illness or death, (d) testimonials, (e) pseudo (imitation) science.
3) Report to the class on your reading of any of the following, all of which describe the difficulties of the consumer in buying wisely: (a) *Read Your Labels* (Public Affairs Pamphlet No. 51, Public Affairs Committee, 22 East 38th Street, New York, N.Y.); (b) *Our Interests as Consumers,* by Dorothy Jacobson (Harper); (c) *Your Money's Worth,* by Chase and Schlink (Macmillan); (d) *One Hundred Million Guinea Pigs,* by Kallet and Schlink (Vanguard); (e) *How to Spend Money* by Ruth Brindze (Vanguard); (f) *Learning to Use Advertising* (Consumer Education Series No. 2, National Association of Secondary School Principals, Washington 6, D.C.).

## *LESSON* 14 CONSUMER CREDIT

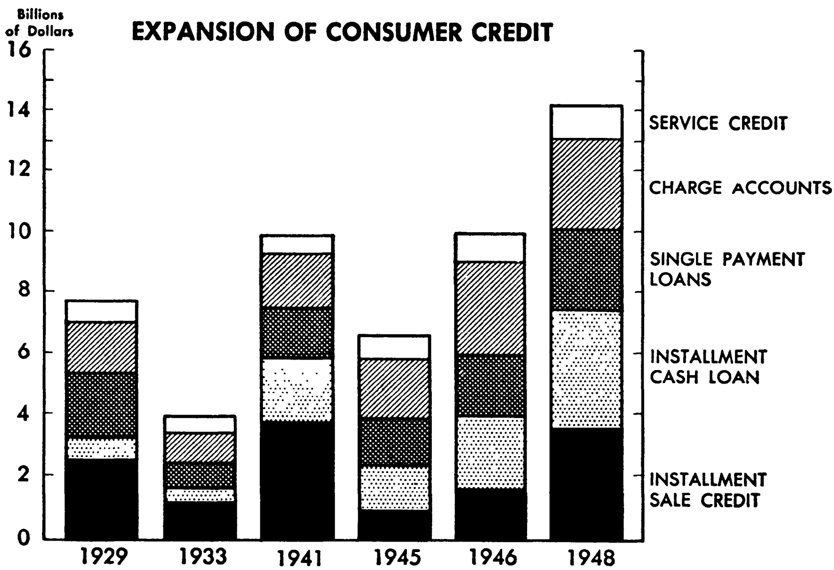
### The Growth of Consumer Credit

Ever since Charles Dickens wrote *David Copperfield,* about a century ago, people in all parts of the world have sympathized with that likable character, Mr. Micawber, who had such difficulty in staying out of debtors' prison. We often quote his maxim, "Annual income twenty pounds, annual expenditures nineteen ninety six, result happiness. Annual income twenty pounds, annual expenditures twenty pounds ought and six, result misery."

In Mr. Micawber's days, debt for consumer expenditures was regarded as a confession of weakness. Debt was justifiable only when money was used for productive purposes, such as carrying on a business, from which the debt could be repaid. True, since the middle of the nineteenth century, sewing machines, pianos, farm machinery, and sets of books have been sold on the *installment plan,* that is, by allowing customers to pay for their purchases in several payments over a period of time. Neighborhood stores have always kept some of their customers "on the book." These were the exceptions, however, to the generally ac-

cepted principle that the way to get goods which were beyond one's ordinary budget was to accumulate the money through patient saving.

About the time of World War I, the automobile industry, developing its mass-production methods, foresaw the great profits to be made by selling automobiles on the installment plan. This method of selling spread to radios, furniture, and household appliances. At the same time, retail stores encouraged customers in the middle income and upper income brackets to open *charge accounts* which allowed them to pay




In 1948 the total was almost twice as great as in 1929. The reduced total in 1933 was a product of depression; in 1945 and 1946 government restriction kept the total low. Have installment sales become a larger or smaller proportion of total consumer credit? Why? (Data from Federal Reserve Board)

once each month for their purchases of the previous month. The use of *personal loans*—loans of money made for personal, rather than business, needs—also increased. The results of this development of *consumer credit* have been phenomenal, as shown in the chart above. "Credit" means the ability to get goods and services now, in exchange for a promise to pay in the future. "Consumer credit" refers to credit used for the purchase of consumer goods and services, as distinguished from credit used by businessmen for the production of goods and services.

There has been considerable disagreement as to whether this development has been a benefit or an evil. Some people hail consumer credit as a means for giving middle-income and low-income families a higher standard of living. As we have seen in our study of Engel's Law, these

families have difficulty in saving substantial amounts. Installment payments on purchases and loans enable them to get goods and services which otherwise they might never be able to buy. It has helped to increase the volume of production, and has therefore reduced the cost of many goods. Consumer credit therefore benefits both consumers and businessmen.

Despite these benefits, however, many people feel that consumer credit has dangerous aspects. It has encouraged many families to overbuy and to overborrow; they forget that credit is not a substitute for income. Installment purchases and loans should be based on the family's average income per year over a long period of time. Consumer credit also helps to bring *inflation*—rising prices—because it increases the demand for goods during periods of high income, when prices may already be moving upward.

For better or worse, there has been a fundamental change of attitude toward personal debt. To owe money is no longer considered a disgrace, branding one as lacking in self-control and thrift. On the contrary, there is a constant advertising pressure upon the consumer to borrow, to open charge accounts, to buy on the installment plan. Just as the consumer is overwhelmed by the variety of merchandise from which he may select the best values, so he is confronted with a wide choice of sources of credit, with a variety of interest rates and other terms. Wise shopping for credit is almost as important as wise shopping for merchandise.

### Mortgage Credit

Another form of consumer credit, besides those already mentioned, is the *mortgage* loan, used in buying a home. Most home buyers borrow a substantial part of the total price, since the purchase of a home involves a large sum of money. In most cases a down payment is made, from one-tenth to one-half of the price, and the balance is financed through a bank. The buyer gives the bank a legal document, promising to pay back the *principal,* the amount of the loan, in a certain time, with a specified rate of *interest.* Interest is a payment for the use of funds. The rate of interest is stated as a percentage of the principal amount of the loan, on an annual basis. As security for the loan, the buyer gives the bank a mortgage on the property. The mortgage is a document stating that if the borrower, or *mortgagor,* fails to pay the interest and principal in accordance with the terms of the sales contract, the lender, or *mortgagee,* may force sale of the property to collect the money still due him; this is known as "foreclosing" the mortgage.

In recent times the danger of foreclosure has been lessened by having the mortgage debt paid in installments. This is called *amortization.* The payments are equal for the entire period of the loan, so that the burden

upon the purchaser will be equal, and easier to budget, from year to year.

Once the mortgage debt has been fully paid, the buyer of the house has a free and clear title to his property and his fixed charges are considerably reduced. In case of need, he is in a position to borrow money by again offering a mortgage on his property as security.

Since the 1930's the Federal Housing Administration (FHA) has helped the banks finance the purchase of new homes and the repair and improvement of old ones. Up to that time, a bank would not ordinarily lend a home buyer more than two-thirds of the purchase price; and a down payment of one-third or one-half the purchase price was too much for people of moderate means. The FHA does not lend money, but it insures banks against any loss on loans they make, up to 80 or 90 percent of the value of a house, provided the construction or improvement plans meet the standards set by the FHA. As a result of this government guarantee, down payments on houses have become smaller, and the mortgage payments have been stretched over a larger number of years. The FHA plan has encouraged the building and improvement of thousands of homes throughout the country.

Look Before You Sign!

In 1936 a legislative committee in Massachusetts studying the problem of consumer credit found that in 105 cases in which storekeepers had advertised installment sales at 6 percent interest, the true rate of interest was as follows:

| | |
|---|---|
| 1 case —6% | 19 cases—21–30% |
| 6 cases—7–10% | 10 cases—31–100% |
| 61 cases—11–20% | 8 cases—101–679% |

Likewise, a Wisconsin committee found that buyers of automobiles who thought that they were paying between 8 and 12 percent were actually paying from 17 to 40 percent, and even more.

How is this possible? The true rate of interest, as distinguished from the stated rate of interest, depends upon these factors:[1]

[1] The distinction between apparent and true rates of interest is obvious in the case of the neighborhood moneylender, who lends a man $10 for a week, saying, "Just give me back $11 on your payday next week." What seems to be a 10 percent interest charge is actually a rate of 520 percent per year.

Then there is the person who buys a $50 radio, pays $20 down, plus an interest charge of 6 percent ($1.80) on the unpaid balance of $30, followed by six monthly installments of $5 each. The true rate of interest is about 21 percent per year because (1) the balance was paid in six months, while the interest rate was figured by the year, and (2) the balance was paid in monthly installments, so that the average amount of money which the purchaser had for his use during the six months was only $17.50. A payment of $1.80 on a 6-month loan of $17.50 makes the true rate of interest 20.6 percent.

1. The stated rate of interest
2. Whether the interest charge is deducted at the time the installment purchase or loan is made, or when the last payment is made
3. The term, or length of time, allowed for payments, and the number of installments
4. Whether there are any different prices for cash sales and for installment sales
5. Whether there are any special charges or fees

Besides guarding against the payment of excessive interest rates, the person who buys on the installment plan or who borrows money must be very careful about the other terms of the contract he signs. He should notice what kind of security he is being asked to give the merchant or lender. In the first place, the contract used for installment sales is usually a *conditional-sales contract.* This means that until the article has been completely paid for, it still belongs to the seller. If the buyer fails to pay an installment in the agreed amount on the specified date, the contract usually says that all unpaid installments come due at once and the seller has the right to *repossess,* or take back, the article. The seller then has the right to resell the article for whatever price it will bring. If the resale price does not cover the balance that was due from the original buyer, the seller may sue the original buyer for the amount of money still lacking. Second, the seller often protects himself further by having the buyer sign a *wage assignment* as part of the contract. The wage assignment gives the seller a blanket right, in case of default on payments, to take part of the buyer's wages each payday, until the balance (plus legal charges) has been paid.

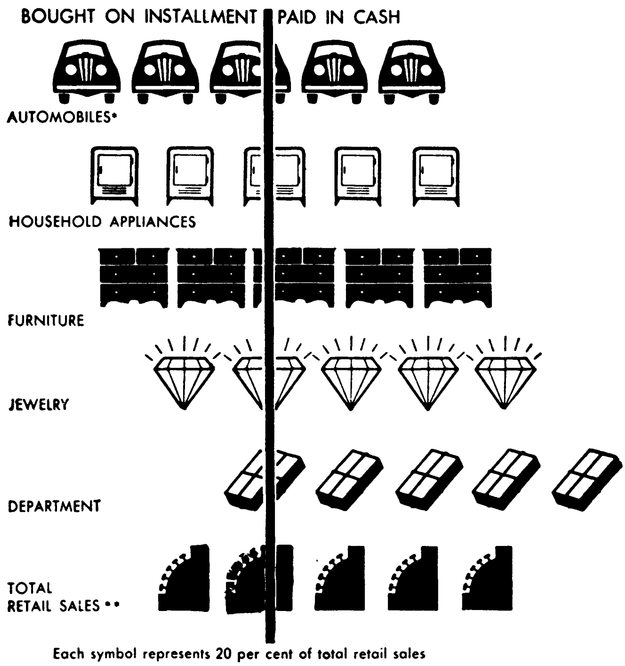
The buyer or borrower is sometimes asked to furnish security for the loan, such as a mortgage on furniture or an automobile. If payments are not made on time and in full, the seller or lender may seize the mortgaged property and sell it, and collect the balance (plus legal charges).

In the case of a personal loan, the borrower is sometimes asked to get a *co-maker* or *co-signer,* another person who will sign the agreement along with the borrower. The co-signer must be someone with wealth or a larger and steadier income than the borrower. By acting as co-signer, he promises that if the borrower fails to make the required payments, he will assume full responsibility for the debt and will make the payments.

Conditional-sales and personal-loan contracts, when used by reliable businessmen in a reasonable way, do not work great hardships upon consumers. In some cases such contracts have been used unscrupulously. Even after a customer has paid most of the balance due, a single tardiness has been used as an excuse for repossessing and reselling the

merchandise or the collateral. Wage assignments have been enforced even when the payments meant depriving the debtor's family of the necessities of life. Workers have sometimes lost their jobs because their employers did not like to be bothered with wage assignments.

HOW MUCH WAS BOUGHT
ON THE INSTALLMENT PLAN 1940?




Each symbol represents 20 per cent of total retail sales

*National Automobile Dealers Association **Estimate of the National Retail Dry Goods Association

SOURCE National Bureau of Economic Research. Duncan McC. Holthausen, 'The Volume of Consumer Instalment Credit, 1929-1938' Department of Commerce

*Pictograph Corporation, for Public Affairs Committee, Inc.*

The proportion of durable goods bought on installments is high. What factors may explain why the proportion of automobile sales on installments is greater than the proportion of jewelry sales? Why are nondurable goods (as distinguished from durable and semidurable) not sold on installments?

PROTECTION FOR THE USERS OF CONSUMER CREDIT

Some states have taken the lead in providing legal protection for small borrowers and installment buyers. The state of Indiana has laws regulating the finance charges on installment sales and prohibiting some of the abuses of conditional-sales contracts. A New York law now requires that the contract shall be printed in a minimum size of type, with

all charges clearly shown, and that the signers shall get copies of the contract. Repossessions and wage assignments are carefully restricted.

More than half the states, notably in the Northeast and Middle West, have adopted the Uniform Small Loans Law, sponsored since 1916 by the Russell Sage Foundation of New York. This law establishes a maximum rate (from 2½ to 3½ percent a month, or 30 to 42 percent a year) which is large enough to make *finance companies*, or small-loan companies, profitable. This encouragement to legitimate finance companies tends to drive out the *loan shark*, the unlicensed lender who takes advantage of people's needs and ignorance to charge exorbitant rates of interest. Moreover, the interest charge made by the finance company is stated as a true rate of interest, so that the borrower knows the exact cost of the loan and need not fear the addition of unspecified charges.

Another essential feature of the Uniform Small Loans Law is the supervision of the finance companies by the state. Lenders must be licensed and bonded and must report regularly to some state agency, such as the banking department. The state agency is in a position to check illegal or undesirable practices, such as false advertising and unreasonable collection methods. The cost of credit under these conditions is still high, especially for the low-income families, who are the chief customers of the finance companies. It is generally agreed, however, that the supervised finance company represents a major improvement over the 300–500-percent loan-shark charges of the unscrupulous lender.

### Rules for Using Credit

The following rules should be observed in using credit:

When you borrow money or buy on the installment plan, it is especially important that you deal with businessmen whom you know to be honest and reliable.

Never sign a document until you have read it carefully, including the parts printed in small type. Do not sign any documents until all blank spaces have been filled in. Notice what kinds of security or collateral you are being asked to provide, and whether you are being asked to sign a wage assignment. Do not be afraid to ask questions about words, clauses, or paragraphs you do not understand. The seller or lender wants you as a customer, and, if he is honest, he will not hesitate to answer your questions. Do not accept any oral understandings, but have them written into the contract.

Comparison shopping is just as valuable in borrowing money as in buying merchandise. When buying something for which you do not have enough cash, figure out whether it would be cheaper for you to buy the article on the installment plan offered by the particular store, or to borrow the money from a finance company and pay cash to the store. Keep in mind all the factors, listed on page 108, which determine the true rate of interest. Com-

pare the true rates of interest charged by various companies and then borrow money where it will cost the least.

From the budget counselors of savings banks and other reputable institutions get advice about buying and borrowing. These counselors will help you plan purchases and loans according to your income and will enable you to avoid financial difficulties.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| amortization | credit | mortgage |
| charge account | finance company | personal loan |
| conditional sales contract | foreclosure | repossess |
| consumer credit | installment plan | wage assignment |
| co-signer | loan shark | |

### II Questions and Problems

1) (a) State and explain two methods by which consumers may acquire goods or services without immediate cash payment. (b) What are the advantages and disadvantages of each method?
2) The late Mayor LaGuardia of New York City for many years carried on a campaign against loan sharks. Why did he regard this problem as important for the entire community?
3) For the past generation there has been much debate about the wisdom of encouraging the spread of installment sales and personal loans. (a) What does the chart on page 105 show about the growth of installment sales? (b) What arguments are there for encouraging the spread of installment selling and lending? (c) What are the arguments against?
4) Make a list of things which a consumer should notice before he signs an installment contract.
5) In what ways do small-loan laws protect borrowers?
6) Figure out the true rate of interest in each case: (a) a radio, priced at \$100 cash, can be bought for \$5 down and \$8.25 a month for 12 months; (b) a piece of furniture can be bought for cash at \$50; or on the installment plan for \$54.50, with a \$5 down payment, and eleven installments monthly of \$4.50; (c) a worker borrowed \$15 from a loan shark and paid back \$2 a week for 12 weeks. Use the constant ratio formula, $R = \frac{2mI}{B(n+1)}$. R is the rate of interest; m is the number of payments per year—12 if monthly payments, 52 if weekly; I is the amount of interest in dollars (whatever is charged above the cash price); B is the balance due; n is the actual number of payments.

### III Things To Do

1) Read and report on any of the following pamphlets: (a) *Loan Sharks and Their Victims* (Public Affairs Pamphlet No. 39); *Credit for Consumers* (Public Affairs Pamphlet No. 5); *Installment Selling:*

*Pros and Cons* (Public Affairs Pamphlet No. 61, Public Affairs Committee, 22 East 38th Street, New York 16, N.Y., price 20 cents each). (b) *One Hundred Problems in Consumer Credit* (Pollak Foundation for Economic Research, Newton, Mass., price about 10 cents). Contains mathematical problems on cost of consumer credit. (c) *Ten Close-Ups of Consumer Credit* (published by Farm Credit Administration, Government Printing Office, Washington 25, D.C., price 15 cents). (d) *Using Consumer Credit* (Consumer Education Series No. 9, National Association of Secondary School Principals, Washington 6, D.C.). A comprehensive analysis of the various kinds of consumer credit.

2) Members of the class should visit whatever types of lending institutions exist in the community, and collect data as to the cost of a loan of $100 in each institution. Newspaper advertisements often give this information.
3) Find out what laws your state has regarding installment sales and personal loans.

# *LESSON* 15 THE CONSUMER AND SAVINGS

## Factors in Saving

We have learned that a family's income is the most important of the factors determining how much the family will save. (See Lesson 8.) The higher the family's income, the larger the proportion of the income which is saved. In a few families the income is so high that it becomes virtually impossible not to save; the process of saving becomes automatic. Most families, however, face the question of how to earn enough money and how to budget their incomes in order to produce a surplus which can be saved.

A second factor influencing the amount of savings is the pattern of spending that is customary in the family. Some people are so fearful of the coming of a rainy day that they save an unusual proportion of their income and correspondingly lower their current standard of living. Others feel that tomorrow will somehow take care of itself and therefore do not even attempt to save. Frequently a family saves with a definite motive: to make a down payment on a house, buy an automobile, send the children to college, pay for a vacation trip, or accumulate capital with which to start a business.

Fortunately for many of us, there is now a third factor which affects savings habits—compulsory savings, resulting from the action of the government, the employer, or some other group with which the saver

is associated. More than half the people in this country have had deductions made from their wages for social-security savings which will protect them in their old age. These deductions are a form of forced saving. So are the deductions made from the salaries of civil-service employees for their retirement pensions. Some labor unions and other groups provide for sickness and death benefits for their members. The payments of dues to such groups contain an element of forced saving.

Most of us think of savings as a personal matter, providing protection for ourselves and our families and helping us raise our standard of living. The importance of savings, however, goes far beyond the individual family. The savings of the individual or family become the capital funds of the businessman. An individual who wants to start a business uses his savings for that purpose. If he does not have enough capital of his own, he may borrow money from a friend or relative who has saved some money. Even if people do not invest their savings in this direct way, but deposit them in a bank or use the surplus money to buy insurance, the savings are soon transformed into capital. The banks and insurance companies invest the deposits and premiums in the stocks and bonds (see p. 175) of business firms, in government bonds, or in the mortgages of builders and owners of real estate.

The family with surplus income is offered a variety of ways to save. Which method it will use depends upon the amount and nature of the savings and upon the aim of the family. It must decide which of three factors is most important: the safety of the savings, the return on the savings, or regularity in saving.

### Owning a Home

One of the most common ways in which saving and consumption are combined is through the purchase of a home. Whether it is better to be a tenant or an owner is not always easy to decide. The tenant has the advantage of knowing just what his cost for shelter is going to be for the period covered by the lease, or rental contract. Maintenance and repair are usually the landlord's responsibility, so that the tenant is unlikely to have any cost beyond the actual rent. The owner of a house has to worry about a variety of costs—fuel, taxes, repairs, mortgage payments, painting. Although these costs are fairly regular, there are unpredictable events which cause some of them to be greater than expected. It is easier for a tenant than for an owner to move about to fit his changing desires and needs. An owner is more closely tied to his property, unless he can afford to take the losses which may result from frequent sales and purchases. On the other hand, in times of housing shortage, as in the 1940's, the tenant has to worry about having his rent increased, or even about being asked to vacate when the lease expires.

The owner has some peace of mind about keeping the roof over his head, although the costs of maintaining his home may have risen. In depression times, like the 1930's, it is the tenant who is often in the better position because he can adapt himself more easily to the shrinkage of income. The home owner is burdened with maintenance costs which may not decline sufficiently to fit his smaller income. If the loss of income is substantial, and the owner's savings are exhausted, he may face the danger of having the mortgage-holder claim the property. This happened in thousands of cases during the 1930's.

**HOME OWNERSHIP — UNITED STATES, 1890-1947**

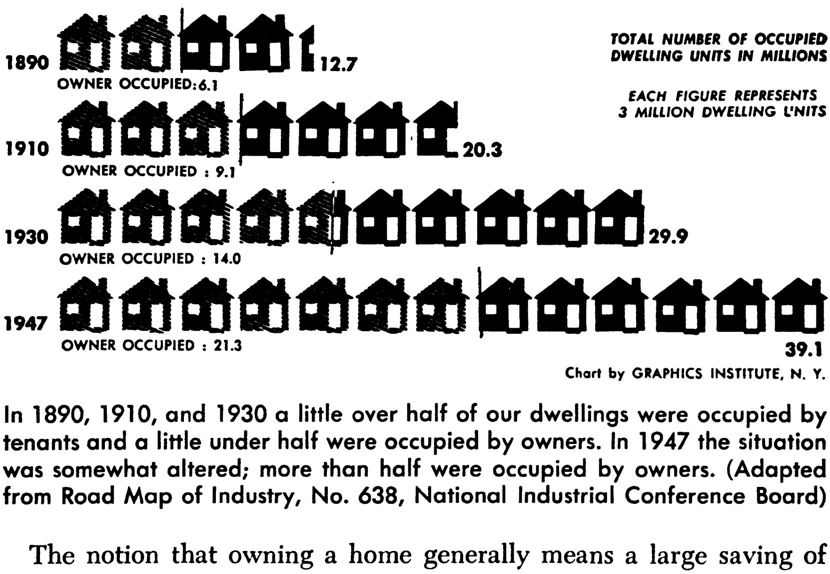



Chart by GRAPHICS INSTITUTE, N. Y.

In 1890, 1910, and 1930 a little over half of our dwellings were occupied by tenants and a little under half were occupied by owners. In 1947 the situation was somewhat altered; more than half were occupied by owners. (Adapted from Road Map of Industry, No. 638, National Industrial Conference Board)

The notion that owning a home generally means a large saving of rent is a mistaken one. The fact that property taxes and interest charges on mortgages are deductible from income taxes may save some home owners considerable amounts. But, despite this saving, the home owner's costs may equal, or exceed, what it would cost him to rent quarters suitable for his needs. It is not so much economy as prestige and comfort that are the chief reasons for buying a home. Owning a home can be economical, even profitable, however, when the house accommodates more than one family; the income from the tenants may be made to cover part or all of the cost of owning and maintaining the house.

### Savings Accounts

Most of us prefer to save money rather than goods. Some people are so distrustful of anything but cash on hand that they hoard money. Under modern conditions there is little justification for this, for money

hoards are subject to loss, theft, and destruction, and they earn no income. When bank failures were frequent, money hoards were common; today the generally accepted method of saving is some form of bank account. For the average American family, the savings account has become a symbol of progress.

The banks receive deposits and give each depositor a bank book in which are recorded deposits, withdrawals, and interest payments. Each bank keeps a certain percentage of its deposits on hand as a cash reserve, so that depositors can withdraw money without delay. The savings bank can by law require the depositor to give sixty days' notice before withdrawing any money, but this power has rarely been used.

It is of the utmost importance that savings banks be managed in such a way as to reduce to an absolute minimum the depositors' risk of not being able to get their money back. To protect the depositors against loss, there is careful regulation of banks by state laws, enforced by the state banking departments. A bank's loans and investments are strictly limited, by the state, to government bonds, the stocks and bonds of exceptionally safe businesses, and real-estate mortgages. The records of the bank are inspected at regular intervals by government examiners. In addition, savings banks may become members of the Federal Deposit Insurance Corporation, a federal agency which insures each deposit up to $10,000.

At the beginning of the century, when bank failures were common, especially in farm communities, there was agitation for the federal government to go into the savings-bank business. In 1910 the postal-savings bank system was organized. Deposits are accepted at post offices, and depositors are given certificates of deposit instead of passbooks. Interest is paid at the rate of 2 percent. Stamps at ten cents each can be bought, and each dollar's worth of stamps can be exchanged for a certificate which draws interest. This savings system is fitted to the needs of the low income groups and is used by many people.

Many families make resolutions each year about saving a certain amount of money every week or every month; but only a small proportion of them keep the resolution. Therefore most people welcome the various methods which have been developed to help them save regularly. One of the most popular is the Christmas Club, run by the savings bank. The saver agrees to deposit a specified amount weekly, and gets no interest on the deposits. The money cannot be withdrawn until a definite date, usually about a month before Christmas. Another method of saving is through a *building and loan association.* If a group of consumers wish to save money for the purpose of buying or building homes, they agree to make regular payments to the association. When the contributions have reached a certain level, the members can borrow

from the association in order to finance the purchase or building of their homes. Those who do not borrow receive interest, in the form of dividends, on their payments.

There are also the Federal Savings and Loan Associations, which are similar to savings banks. They often pay somewhat higher rates of interest than savings banks, but withdrawals may sometimes be a little more inconvenient.

### Banking Services for Consumers

Savings banks should not be confused with commercial banks, which deal mainly with businessmen. In commercial banks the depositors may withdraw money by writing *checks* (see p. 197) whereas in savings banks the depositor can withdraw money only by coming personally to the bank and presenting his passbook. Many commercial banks do, however, have a special interest department, which operates like a savings bank within the commercial bank. Many commercial banks also have checking accounts for consumers. If a consumer keeps a large enough balance in a commercial bank (usually from $100 to $500), he can have a commercial account and can draw checks as needed. If he cannot maintain the minimum balance, he may open a special checking account and have the privilege of drawing checks, by paying a service charge for each check drawn.

Savings banks do not offer any kind of checking account, but they do sell their own checks to depositors, making a small service charge for each check. To secure such a check, the depositor must apply at the bank in person, and have the check written by the bank teller. Such checks are similar in use, though not in appearance, to the money orders which can be bought at the post office.

Banks also sell books of *traveler's checks,* in definite denominations, which can be used to make payments in other cities or foreign countries. This makes it unnecessary to carry large amounts of cash when traveling. The buyer of the traveler's checks pays the full value of the checks in advance, plus a service charge.

Another service which both savings and commercial banks offer is the *safe deposit box.* For a few dollars a year a person can rent a box in which to keep leases, insurance policies, bonds, jewelry, and other valuable documents or goods.

### Saving Through Investment

It is possible to save money by buying the stocks of business firms, or the bonds of business firms or the government. The nature of these securities will be discussed later. Since investments in business corporations involve a degree of risk, most consumers of moderate income, to

whom savings are a reserve for a time of need, leave this type of investment to the experts. The savings bank is an expert and safe agency for the investment of savings. The saver brings his money to the bank as a deposit, which the bank puts to work as an investment in securities of one kind or another. From the earnings on this investment the bank pays its operating expenses, and then pays the depositors their share of the earnings in the form of interest on their deposits. In recent years the interest rate has usually been 1½ or 2 percent. Although the saver

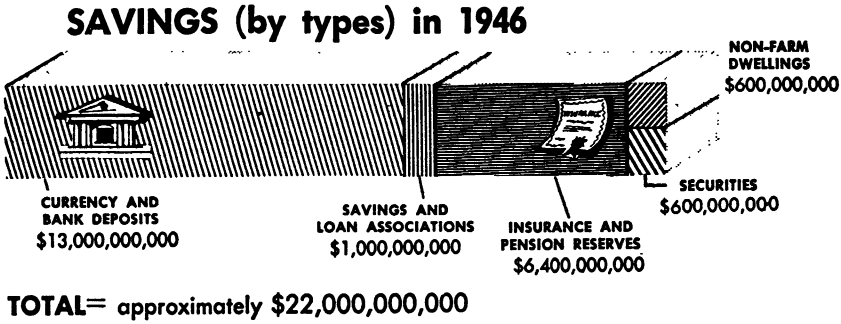



Chart by GRAPHICS INSTITUTE, N. Y.

This is a 100% bar chart. The printed data, however, state total savings rather than percentages. Bank accounts made up about $\frac{2}{3}$ of total savings; life insurance accounted for the bulk of the remainder. (Data from Twentieth Century Fund)

generally gets a smaller return from the savings bank than he might get from doing his own investing, he is freed from worry about risks.

Saving through government bonds is done by individuals, business firms, and nonprofit organizations of all kinds. For large savers the government issues bonds in high denominations, generally $1000. For people of moderate income there are savings bonds, or baby bonds, in denominations of $25 and up. These small bonds do not pay interest at regular intervals, as in the case of the larger bonds; instead, interest is paid all at once when the bond is cashed by the holder. If, for example, one buys a bond for $18.75, it will be worth $25 at the end of ten years. This represents an interest rate of about 3 percent. The bond can be redeemed, or cashed, any time before the ten-year period ends; the longer the bond is held, the greater is its value when cashed. The rate of interest of government bonds is slightly higher than that paid by the savings bank, but there is somewhat greater inconvenience in buying and cashing bonds than in making deposits and withdrawals. To some people this inconvenience seems a good way to check impulsive spending and to encourage permanent saving. Buying government bonds is also a way of supporting the activities of the government. During the

war these savings bonds were one of the means by which the government financed the nation's military effort.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| building and loan association | savings account |
| compulsory savings | traveler's checks |

### II Questions and Problems

1) (a) Why may it seem harder to save money now than it did thirty or forty years ago? (b) Why did savings reach record levels during the 1940's?
2) What changes have taken place, over the past hundred years, in the methods and forms of saving?
3) Explain why the savings bank might be described as an institution for coöperative investment.
4) Describe three ways in which the government protects savings-bank depositors against loss.
5) Make a list of the various ways in which people can save money, and arrange these methods in the order in which they should be used by the average family.
6) How may the opportunities and profits of businessmen be affected by the changes in the proportions of spending and saving?
7) In parallel columns summarize the advantages of home ownership and tenancy. Which advantages are greater at the present time? What circumstances might change the present situation?

### III Things To Do

1) From the savings banks in your community, collect pamphlets and other materials which describe the problems of saving, and the services of savings banks to consumers.
2) Read and report to the class on any of the following discussions of the problems of family budgeting, methods of saving and investing, and buying a home: (a) *Women and Their Money* (Public Affairs Pamphlet No. 146.) (b) *Money Management for the Family,* pamphlet published by the Household Finance Corporation. (c) *Managing Your Money* (Consumer Education Series No. 7, National Association of Secondary School Principals, Washington 6, D.C.). (d) *How to Live Within Your Income,* by Lasser and Porter (Simon and Schuster, 1948).
3) Get advice from a bank or real-estate agency in your community on this problem: A family of four (1 son, 1 daughter) with an income of $80 a week wishes to buy a home. How much (total purchase price) should they spend for a house? What would the down payment be? What would be the monthly costs for interest, amortization,

taxes, heating, and repairs? How would the monthly expense compare with the rent which this family would normally pay for living quarters?

4) Make a report on the various types of savings institutions available in your community—savings banks, postal savings, building and loan associations, for example.

# *LESSON* 16 LIFE INSURANCE

## What Is Insurance?

*Insurance* is a plan for dividing among a group of people the financial loss which any member of the group may suffer from death, illness, fire, theft, or other such hazards. Each member of the group contributes to a pool of money, from which those who suffer a loss receive a specified compensation. Suppose a thousand people decide to organize a coöperative insurance plan which would pay the family of each member $2000 upon the death of the member. Each person who participates in the plan is taking the risk that he will pay more into the pool than his family will collect from it. On the other hand, he knows that, in the event of his death, his family will not suffer a sudden financial disaster.

## Premiums and Benefits

Each year the organization will have to collect from its members enough money to pay the claims of that year. It will estimate the number of deaths that will take place among the members that year, multiply the number by $2000, and divide this amount by the number of members, which in this case is one thousand. In actual practice the organization would not rely upon a mere guess. As a result of years of experience, statisticians, known in the insurance business as *actuaries,* have computed a *mortality table,* which gives the number of deaths per thousand which can be expected at every age. If, to make the example simple, all the one thousand members of the organization are forty-five years old, then, according to the mortality table, eight of them will probably die during the year. In order to be able to pay the claims of the eight families of the deceased, the organization will need $16,000. Each of the thousand insured persons will therefore have to pay a premium of $16 for a policy with a face value of $2000. The *premium* is the amount regularly paid for insurance. The *face value* is the total amount of money which will be paid when the policy becomes due. The following year, however, and every succeeding year, as the members grow

older, the number of deaths per year will increase, and the number of premium-payers will decrease. Hence, if no new members are added, the amount of the premium will grow each year until the cost becomes prohibitive for the last survivors. The annual premium at the age of 65 would be about $125 for the $2000 policy. This system of increasing the cost each year according to the amount needed for claims is called the *assessment method.*

To avoid the difficulties of the assessment method, insurance companies have instituted the *level-premium* method of payment. Under this plan the low premiums of the early years and the high premiums of the later years are averaged, and the insured pays the same premium during the entire life of the policy. In this way the insurance company, during the early years of the policy, collects more than enough to pay the current claims of the *beneficiaries,* those named in the policies to receive the *benefits,* which are the payments due under the terms of the policy. In the later years of the policy, the company collects less than the current claims, but it has the surplus from the early years to make up the difference.

The premium is affected by other factors besides the cost of the death claims. The premiums have to be large enough to pay not only the benefits promised in the policy, but also the operating expenses of the insurance company—rent, salaries of officials and clerical staff, commissions of agents, and advertising. These costs raise the amount of the premium. On the other hand, the insurance company invests the premiums in stocks and bonds, mortgages, and other safe investments. The more the company earns on its investments, the lower the premiums can be.

Policy holders must note that the *net cost* of the policy to the insured is also affected by the amount of the *dividend* which he may receive. This is an amount of money which is paid back to the insured annually. The dividend is made possible by two factors: (1) the number of death claims may decline from the number shown in the mortality table, because of the continuous lowering of the nation's death rate; (2) the earnings of the company may be greater than were expected when the premium was set. The larger the dividend, the smaller the net cost of the policy to the insured.

### Insurance as a Means of Saving

Many people who buy insurance are interested not only in getting protection for themselves and their families, but also in forcing themselves to save money regularly. For that reason, the premiums of all life-insurance policies (except term-insurance policies, which are explained later) are large enough to cover the cost of the specified pro-

tection and also to leave an extra amount to be accumulated as a savings fund. This accumulation is credited to the account of the insured as a cash reserve and earns a certain amount of interest each year. The cash reserve is very small in the early years of the policy because of the few premiums paid in and because of the high commissions and other expenses in the early years.

This cash reserve can be used by the insured in various ways. In case of need he can borrow the cash reserve, in the same way that he would borrow from a bank, paying interest on the loan. If he decides to let the policy lapse (drop), he gets the cash reserve as the *cash surrender value* of the policy. If, when the policy lapses, he does not need the cash particularly, he can get *extended-term* or *paid-up insurance;* that is, without further premium payments he can have a specified amount of insurance for a specified time, according to the amount of the cash surrender value.

Saving money through an insurance policy is an expensive way of saving. The most economical way for the average person to save money is to deposit it in the savings bank, and to get as much protection as possible by buying the cheapest kind of insurance policy. Yet many people prefer to use the more expensive method of saving money through an insurance policy, because it makes their saving compulsory and therefore more regular than it might otherwise be.

Insurance policies are one of the ways in which people save money and thereby help to provide capital for business firms. At the end of the 1940's, the life-insurance companies of this country were collecting about five billion dollars a year in premiums and had total assets of about fifty billions. About one-third of these assets were invested in mortgages, bonds, and stocks of private businesses; and another third in the bonds of our federal, state, and local governments.

### Types of Policies

One of the difficulties confronting the prospective purchaser of life insurance is that of choosing from the perplexing variety of policies available. One insurance company alone sells a hundred different kinds of policies. All policies may be classified, however, under four standard headings:

1. *Term insurance* is life insurance for protection only, not for savings. It is bought for specific periods of time—one year, five years, ten years, and sometimes twenty years—often with the privilege of renewal for another term. Since the premium is just high enough to cover the actual cost of the claims paid by the company, the insured does not accumulate any cash reserve.

The advantage of term insurance is that, in the early years, it is less

expensive to the insured than any other type of policy. For a given amount of money the insured gets the maximum amount of protection for his family. The money saved on the insurance can be deposited in a savings bank, and will provide more savings than the cash reserve of other types of policies. The drawback of term insurance is that each time the policy expires and is renewed for another term, the rate increases.

Term insurance is most desirable for people in their twenties, thirties, even forties, when the cost is low. The family of the insured gets the greatest amount of protection during the period when the need of the family for such protection is greatest—while the children are young. By the time the children have grown older, it may be advisable to change to some other type of insurance before the cost of these other types becomes too high.

2. *Straight (whole) life insurance,* like term insurance, requires that premiums be paid for the entire lifetime of the insured. It costs more than term insurance because it includes a cash reserve. It provides less protection per dollar of premium than term insurance. On the other hand, it provides a level premium for the entire lifetime of the insured. For many families it provides the most practical combination of insurance and savings.

3. *Limited-payment life insurance* requires premiums for a limited number of years—fifteen, twenty, or thirty. The smaller the number of years, the higher the premium will be. After the premiums have been paid for the specified term, the policy remains in force for the lifetime of the insured without further premium payments. The cash reserve has by that time become big enough to take care of the cost of the insurance for the remainder of the insured person's lifetime. The cash value continues to earn interest each year, so that it grows from year to year. This kind of policy is particularly suitable for businessmen, professional people, and salaried workers who want to pay the entire cost of their insurance during their middle years, when, in most cases, their earnings are at a peak.

4. *Endowment insurance* differs from the other types of policies in that it matures after a definite number of years. When the policy matures, the face value of the policy is paid to the insured. If the insured dies before the date of maturity, the beneficiary receives the face value, as in other types of policies. The premium for an endowment policy is higher than for straight life insurance, because it has a larger investment element.

Similar to the endowment policy is the *annuity* policy. When the policy matures, however, instead of receiving a lump sum, the insured receives regular monthly payments for the rest of his life.

METHODS OF DISTRIBUTION OF LIFE INSURANCE

There are four ways in which people generally buy life insurance.

*Ordinary insurance* is sold in policies of $1000 and up. It is issued only to individuals, and each individual must pass a medical examination. The premiums are paid annually, semiannually, or quarterly, sometimes monthly. Ordinary insurance includes all the types described above.

*Industrial insurance* is sold to workers in small policies, most of them less than $250 each. A medical examination is usually not required. Premiums may be paid weekly, and are usually collected by an agent, who comes to the insured's home or place of business. Because of the high cost of handling, this form of insurance is very expensive; that is, the amount of protection per dollar of premium is very low. Yet it is sold almost entirely to low-income workers, who need cheap insurance. For a long time it has been argued that a large proportion of American workers are unable to provide themselves with a reasonably adequate amount of life insurance. Even the tiny industrial-insurance policies seemed to be a luxury for many of them. During the ten years from 1928 through 1937, for example, American workers bought 167,000,000 new industrial policies, but at the same time 132,000,000 industrial policies lapsed. The attempt is now being made to meet their insurance needs through social security, group insurance, and savings-bank life insurance.

*Group insurance* is sold to a group of people, usually a group working for the same employer, or the members of a labor union, or the members of a fraternal group or coöperative. No medical examination is required. The premiums are usually low because the distribution is on a wholesale basis.

*Savings-bank life insurance* was established in Massachusetts in 1907, and more recently in New York and Connecticut. The customer has to go to the bank to purchase this insurance. Because the savings bank does not pay any agents' commissions, and since the collection cost is slight, the premiums on this form of life insurance are lower than on ordinary insurance. In New York no bank may sell more than $5000 worth of savings-bank life insurance to any one individual; in Massachusetts the limit is $25,000; in Connecticut, only $3000.

### SOME RULES TO FOLLOW IN BUYING LIFE INSURANCE

1. Try to get the advice and services of an experienced and well-established insurance agent in whom you can have confidence. Beware of high-pressure methods of salesmanship.

2. All the well-known companies are reliable and safe. The important thing for a buyer of life insurance is the net cost of the policy over a period

of years. In comparing policies, keep in mind not only the premium, but also the cash reserve and the dividends.

3. For many families, especially for young families with small incomes, the most economical kind of insurance policy is term insurance or savings-bank life insurance, where available. In this way the family gets the greatest possible amount of what it needs most—protection. Later, as the family grows older and its income increases, a shift can be made to policies with level premiums and savings features.

4. Education policies and other forms of endowment policies are a more expensive method of saving, most suitable for middle-income and upper-income families.

5. Don't overbuy. Your total premiums should be no more than you can reasonably afford with what is likely to be your average income over the years. If your income increases beyond expectations, you can add further insurance at that time. The greatest waste in buying insurance is to buy a policy and then allow it to lapse in a few years, because during those early years the cash surrender value is so very small.

6. Ordinarily, it is unwise to shift from one policy to another, because there is a financial loss. If you are urged to do so by an insurance salesman, try to get expert advice from another source.

7. Read your policy carefully from beginning to end. It is a long and tedious assignment, but important to your welfare. Ask your agent to explain the various sections, especially those outlining the benefits, cash values, loan features, and other rights which you may have under the policy.

8. It is usually advisable to pay the slight extra cost of waiver of premium. Then, if you are disabled, you do not have to pay the premiums, but your policy continues in force.

9. If you are a veteran, keep your government insurance policy. It is the best insurance value available.

10. It is usually to the advantage of the buyer of life insurance to plan a long-term program with a qualified underwriter (insurance sales firm). There is a National Association of Life Underwriters, with local or regional branches, which maintain ethical professional procedures in life-insurance sales. You can always seek their advice.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| actuary | group insurance | net cost |
| annuity | industrial insurance | ordinary insurance |
| beneficiary | insurance | paid-up insurance |
| benefit | insurance dividend | premium |
| cash surrender value | limited-payment insurance | savings bank life insurance |
| endowment insurance | mortality table | straight life insurance |
| face value | | term insurance |

II QUESTIONS AND PROBLEMS

1) What is the basic principle of all insurance?
2) Copy and fill in this table comparing forms of insurance:

| | Types of Insurance | | | |
|---|---|---|---|---|
| | *Term* | *Straight Life* | *Endowment* | *Annuity* |
| Rank according to cost | | | | |
| Rank according to protection | | | | |
| Rank according to savings | | | | |

3) Explain why net cost is so important in choosing a policy. What factors determine the net cost?
4) The figure indicates that the average life-insurance policy is kept only about seven years before it is lapsed. (a) Why is this fact of great significance to buyers of life insurance? (b) What criticism of insurance companies might be made on the basis of this fact?
5) Economists have cautioned against confusing insurance aims and investment aims. What do they mean?
6) What kind of life-insurance policy, in your opinion, should be recommended to each of the following: (a) a man 24 years old, single, with no dependents, holding a good job; (b) a man 30 years old, married, with one child four years old, receiving a steady and fair-sized income; (c) a man 48 years old, with one child married, and a second child in college; man and wife both civil service employees, members of pension system giving them retirement pension and death benefits.
7) The insurance companies of this country have become one of the important sources of business capital. How?

III THINGS TO DO

1) Read and report about the principles and types of insurance in any of the following: (a) *Buying Your Own Life Insurance* (Public Affairs Pamphlet No. 134). (b) *Buying Insurance* (Consumer Education Series No. 8, National Association of Secondary School Principals, Washington 6, D.C.). (c) Materials published by the Institute of Life Insurance, 60 East 42nd Street, New York, N.Y.
2) Report to the class on the controversy which has developed regarding term insurance. For material in favor of term insurance, you can read Consumers Union *Reports* of 1938–39, 1942; *Life Insurance: A Legalized Racket* by Mort and Gilbert (Farrar and Rinehart); *Your Life Insurance* by David Gilbert and J. P. Sullivan (Marlowe). For material against term insurance, read *Term Insurance* by M. A. Linton (National Association of Life Underwriters, 1939); *Life Insurance Speaks for Itself* by M. A. Linton (Harper, Rev. Ed., 1939).

# LESSON 17 EDUCATING THE CONSUMER

### Johnny Consumer Comes of Age

Johnny Consumer of our cartoon story (pages 128–9) learned how much his standard of living depended upon wise buying. To be a wise consumer is a highly complicated business. It requires knowledge about thousands of goods and services, weights and measures and their standardization, savings, credit, and insurance. There is a saying that "To spend money is easy; to spend it well is hard."

Most consumers do not realize how little they know about efficient methods of buying goods and services. Few people make even an attempt at learning the rules of spending and using. No wonder one economist, Wesley C. Mitchell, entitled his essay on consumer problems *The Backward Art of Spending Money!*

Recently, however, we have had the beginnings of a *consumer movement.* This is the attempt to establish agencies which help consumers get more for their money. In a short time, the consumer movement has accomplished a great deal. Largely as a result of the pressure from consumers and consumer organizations, our federal and state governments have passed many important consumer laws, and businessmen have made great improvements in their products. At the same time, consumers have learned a good deal about wise buying.

As a result of the work being done by schools and by consumer organizations, more people realize that their real income depends not only on their earnings but also on the way they spend; that they need legal protection not only as workers, investors, or manufacturers, but also as consumers. As the consumer "comes of age," he becomes a consumer-minded person, one who sees problems from the consumers' viewpoint.

### Consumer Education in Schools

Our youthful Johnny Consumer became a wise consumer, but not by chance. Even before he was of school age, he learned wise buying by shopping carefully with his parents. They also helped him choose good forms of recreation and entertainment, and he became a wise consumer of his leisure time.

It is primarily in connection with this latter type of activity that our schools have engaged in consumer education. Most of such teaching is, indeed, usually not recognized as consumer education. It is that part of our education that teaches the appreciation of good literature, music, and art, and provides recreation and health education in the gymnasium and in biology and other classes.

Only recently has the study of wise buying come into the classroom. In shop classes and in home-economics classes, many schools are teaching about goods and their uses. Many teach consumer economics—budgeting, life insurance, and commercial law. Some of this information reaches the adult population through evening courses and through mimeographed materials sent home with the children.

One of the most interesting and promising experiments in consumer education is the work of the Projects in Applied Economics, conducted under the auspices of the Alfred P. Sloan Foundation. In some states the universities are working with the elementary and high schools to develop reading materials that teach practical lessons on clothing, food, housing, and many other aspects of daily living.

### General Information for Consumers

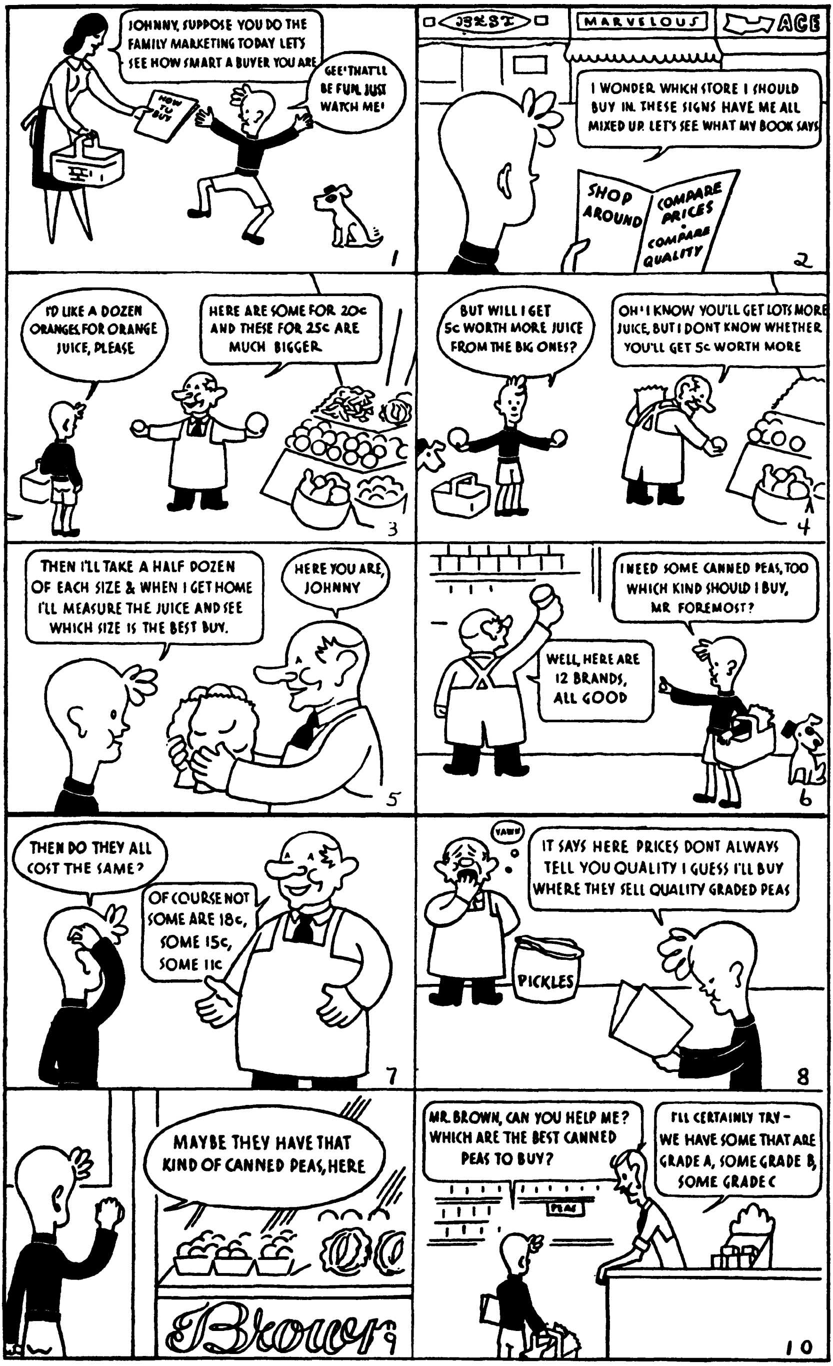
Many agencies provide information and guidance for the bewildered consumer. Private organizations which supply consumer information of one kind or another are numerous. The most obvious and most widespread source of information is of course advertising, which provides much necessary information for buyers, but can hardly be expected to state the bad points of a product. In a similar class are the catalogues of the mail-order companies. Many newspapers and magazines devote a good deal of space to consumer information. They tell what food products are currently selling at reasonable prices, and they suggest how to prepare food economically and at the same time obtain the most value out of it. They also give advice on mending and repairing, and hints on home decoration and similar subjects.

There are numerous pamphlet series on consumer problems. Professional and educational associations, women's clubs, and labor unions issue consumer literature.

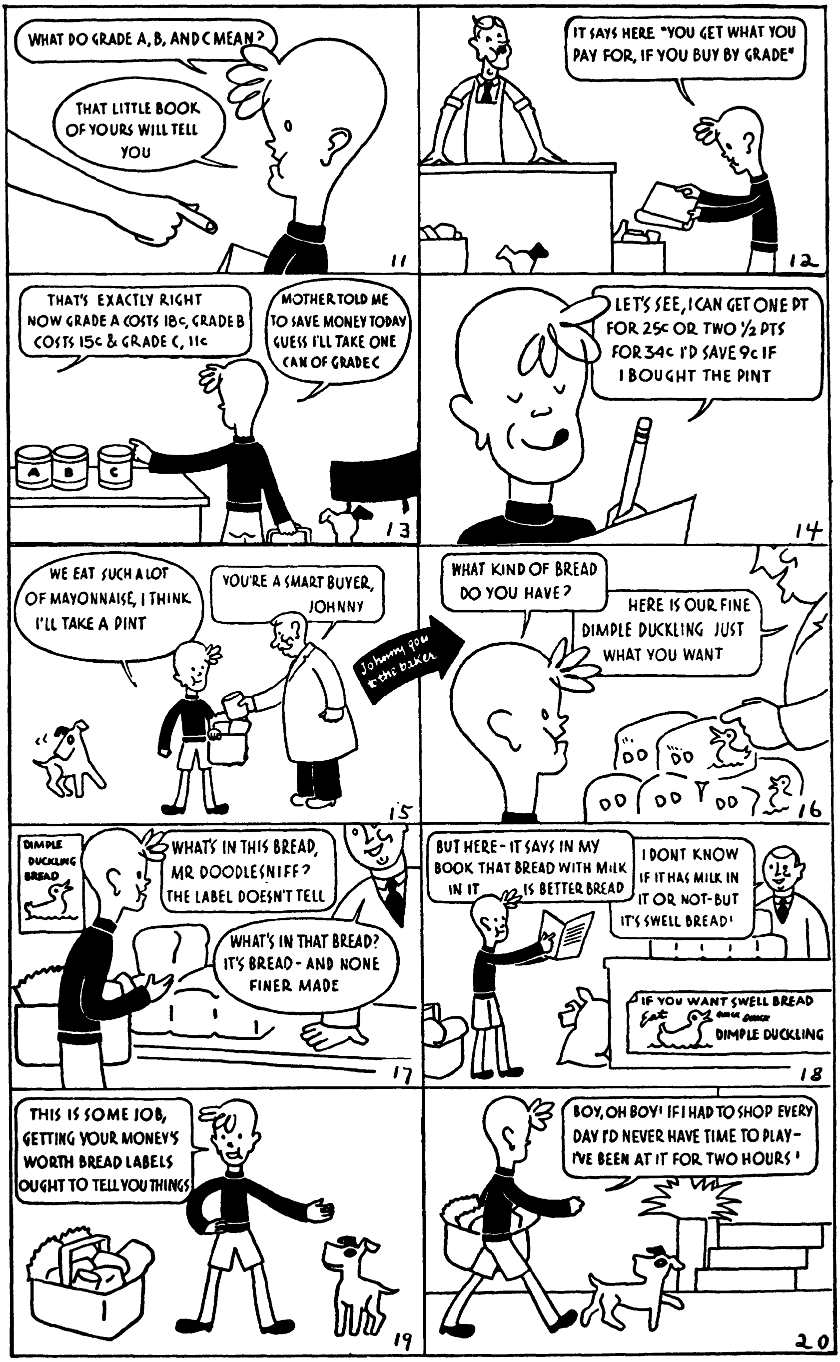
*Better Business Bureaus* have been established in many cities by coöperating business firms. They protect the public, by publicity and advice, against some of the grosser business frauds, such as false advertising. Many pamphlets published by the Better Business Bureau are available to consumers.

The National Consumer-Retailer Council (8 W. 40th St., New York 10, N.Y.) represents an experiment in coöperation between the consumer and business organizations. It encourages the use of informative labeling by producers and the buying by consumers of products that have informative labels. (See Lesson 18.) It seeks to help retailers and consumers to understand each other's problems, and tries to improve dealings between them.

Government agencies also provide a good deal of consumer information. The activities of state and local governments vary considerably.




*JOHNNY CONSUMER . . . a youngster encounters buying problems.* **This a publication formerly issued by**




cartoon strip is reproduced (in part) from *Consumers' Guide*, January 2, 1941, the Department of Agriculture.

An example is the work of New York City's Division of Consumers' Service and Research, a branch of the Department of Markets, which carries on the following activities: radio broadcasts to housewives over the city station, giving up-to-the-minute news on the selection, preparation and care of food, and facts about the supply and price of foods in the local markets; free cooking classes; publication of moderate-cost menus; publication of free booklets on the preparation of foods. The extension divisions of state colleges are a rich source of information on nutrition, homemaking, and other consumer problems.

The federal government participates in consumer education mainly through various branches of the Department of Agriculture. It deals mainly with farmers and rural people through Home Demonstration Clubs and radio programs, but many of its pamphlets are useful for city people as well. Examples of these are "Stain Removal from Fabrics," "Guides for Buying Sheets, Blankets, Bath Towels," and "Cheese in Your Meals."

### Testing Services

Among the consumer testing organizations are Consumers Research (located at Washington, N.J.), Consumers Union (38 East First Street, New York 3, N.Y.), and Intermountain Consumers Service (Denver 5, Colorado). These organizations are owned by the consumers themselves, that is, by all persons choosing to become members at the subscription rate of a few dollars a year.

Let us examine one of the reports of a consumer testing organization. It contains articles about cameras, ball-point pens, fountain pens, electric shavers, dentifrices, and records. Each study has three parts: (1) it describes the standards set up for judging and comparing the different brands of the product, (2) it describes the testing methods used in analyzing the product, and (3) it rates the various brands in order of quality and cost per unit. The article on dentifrices, for example, rates 108 different brands of tooth paste, powders, and liquids.

These organizations labor under several serious handicaps. They have a small membership, they carry no advertising, and therefore their funds are limited. This limits the amount of testing they can do.

Governments provide testing services to a limited degree. The federal government has a Bureau of Standards which tests products bought by the government for use in its offices, in its hospitals, in the Army and Navy, and in other agencies. But as far as the general public is concerned, only the specifications or standards set up by the Bureau are available; the names of the brands that succeed or fail in meeting these standards are not divulged.

WHAT CAN BE DONE?

The handicaps that stand in the way of improved consumer education are difficult to overcome. The consumer is generally not even aware of his ignorance. Furthermore, it takes time and energy to study; and most adults, particularly housewives, have little time and energy left after a day's work. When the consumer does make an attempt to get at the facts, he is often confronted with conflicting statements; reliability of the source is difficult for the individual to determine. Government agencies are likely to be reliable, but the extent of the information available from government sources is limited.

During the recent war some of the possibilities of consumer education were realized. The federal government, working in coöperation with many other agencies, reached down into the neighborhood communities to organize and inform the consumer. Under this stimulus, volunteer groups were organized to help enforce price control, to learn the elements of nutrition, to run "swap shops" for clothing and household articles, and in many other ways to improve consumer and national welfare through mutual assistance. These wartime experiences gave consumer organizations a basis for believing that a sustained peacetime program of consumer education could improve our standards of living.

## Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

Better Business Bureau     consumer movement

II QUESTIONS AND PROBLEMS

1) Using the following topic headings, make a complete outline of Lesson 17 by adding subtopics:
   A. The Consumer Movement
   B. Consumer Education in Schools
   C. General Information for Consumers
   D. Testing Services
   E. Further Measures for Consumer Education
2) In 1912, Wesley C. Mitchell wrote an essay entitled, "The Backward Art of Spending Money." Explain the possible significance of the title.
3) How has the course of study you have been following in your school contributed to your education as a consumer? Explain.
4) "Teaching people to read is the most important measure for making them intelligent consumers." Explain and illustrate this statement.

5) (a) Explain the purposes and services of consumers' testing agencies. (b) What are their advantages and limitations for the consumer and the community as a whole?
6) Explain how each of the following assists in your education as a consumer: (a) your local government, (b) your state government, (c) the federal government.
7) Explain specifically how you could secure information on (a) the best value in television sets, (b) how to prepare a budget, (c) the best grade of a canned product.
8) Explain two difficulties in the way of improving consumer education.

III Things To Do

1) Report to the class on the types of consumer literature made available by the Department of Agriculture.
2) Organize a debate or panel discussion on one of the following topics: (a) Should the federal government do the work now done by consumers' testing agencies? (b) Should all high schools give a course on the nature of consumers' goods?
3) With your classmates, plan a short dramatic sketch illustrating one of the ideas you have received from this lesson.
4) Read (a) "Consumer Problems" in the *Building America Series,* (Grolier Society, New York); (b) *Using Dollars and Sense* by Oliver R. Floyd and Lucien B. Kinney (Newson); (c) *Consumer Goods* by Edward Reich and C. J. Siegler (American Book Co.); (d) *Know Your Merchandise,* by Wingate, Gillespie and Addison (Harper, 1944). The last two references give consumers information regarding specific types of goods.
5) Consult the references on page 104 for additional reading.
6) By consulting your school and public libraries, or by writing to the offices of the organizations involved, secure information on the work of any of the private agencies mentioned in this lesson. Write a report on this topic.

## *LESSON* 18 STANDARDS AND LABELS

### The Present Confusion

In 1904 fire swept the city of Baltimore. Fire hose were rushed by rail from Washington, Philadelphia, and New York to help fight the conflagration. Most of the hose could not be used, however, because they did not fit the Baltimore hydrants.

Even today there are numerous situations in which the confusion of

the consumer is similar, though he has become so accustomed to them that he hardly notices them. A man may wear size 7 shoes and size 10 socks. A bushel of potatoes, by the laws of the various states, weighs 60 pounds in one state, 56 pounds in 5 states, 55 pounds in 5 states, 54 pounds in 10 states, 50 pounds in 14 states, and 46 pounds in 1 state.

Even worse is the chaotic situation in the measurement and description of quality. On most articles, producers are not required to indicate the quality of their merchandise. If they do give some description, each producer is free to use whatever terms he pleases. Such terms as "fancy" and "choice" have different meanings from one producer to another.

It is very difficult for a consumer to judge quality. When he buys canned foods, he has no definite knowledge about the quality of the ingredients which have been used. Nor can he tell much about the wearing qualities of materials, such as durability, shrinkage, or fastness of colors. Without some standardized measurement of these qualities, the consumer finds himself buying largely by guesswork.

A uniform, generally accepted method of measuring or describing a product or any of its characteristics (weight, length, strength, quality, etc.) would make it easier for the consumer to buy intelligently. If uniform measures of quality were used, the consumer could compare the values of different brands and could choose products according to the specific purpose he had in mind. If he wanted to be economical, he might choose an inferior product, if he could get it at a lower price. If he were interested in quality, he might be willing to pay more, if he could be sure that he was getting better quality. Price and quality would be more definitely correlated.

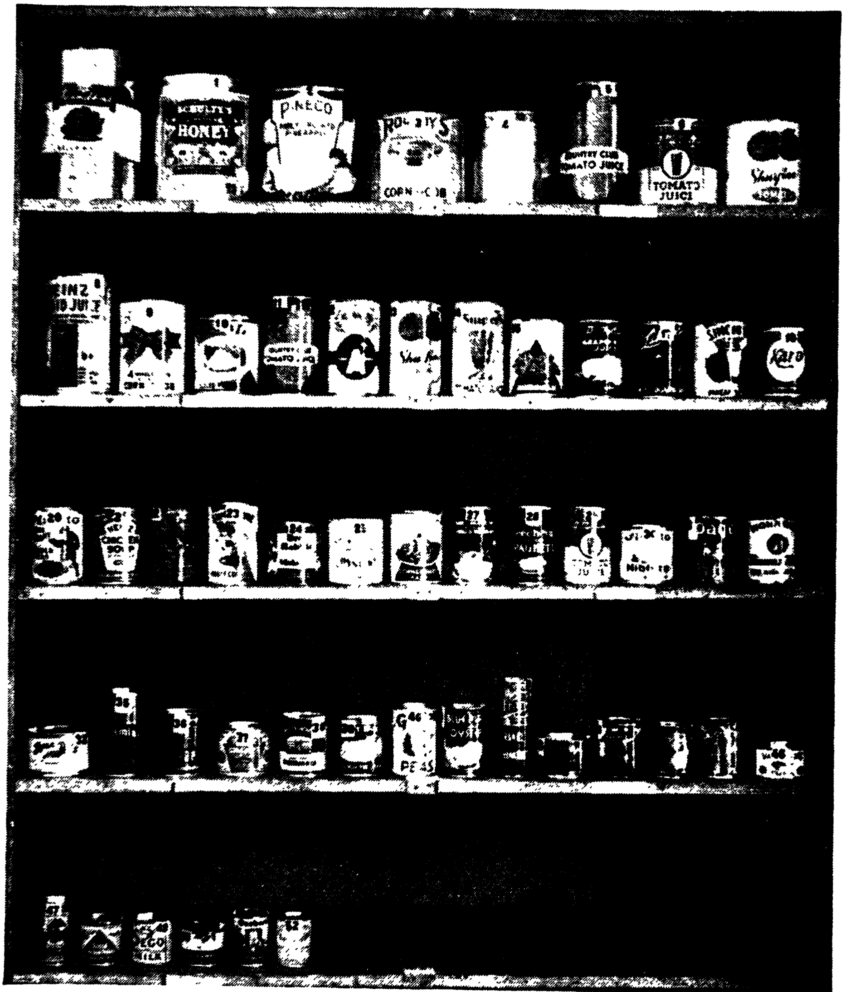
### The Meaning of Standards and Standardization

The men who planned our government in 1787 wrote into the constitution: "Congress shall have the power . . . to . . . fix the standard of weights and measures" (Art. 1, Sec. 8). However, Congress has not taken full advantage of this power; nor are the states required to follow these national standards when they are set.

A *standard* is a unit or device which, by law or general usage, has been established as the measure of the quantity, quality, performance, or value of things. The National Bureau of Standards has legally defined the length of an inch; in Washington there is a hermetically sealed case containing a bar which is a standard inch in length. Using this standard, we all get identical results when measuring length. In school, general usage makes 100 the mark for perfect performance, and 60 or 65 may be used as the standard for measuring passing and failing. *Standardization,* then, means the setting of standards (or measures) by

which the quantity, quality, performance, or value of things may be judged.

The setting of standards of quality is of course much more difficult than the setting of standards of length and weight. Some qualities—for



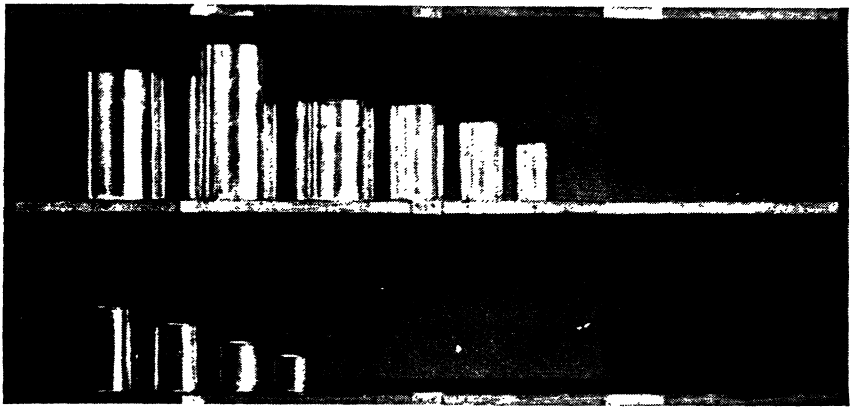
Consumers' Guide, *U.S. Dept. of Agriculture*

**Here are 52 can sizes of an estimated 150 that appear on shelves of food stores where consumers shop. Compare this with the photograph opposite.**

example, the beauty of a hat—cannot be standardized at all; these are matters of personal taste. However, through scientific processes, the qualities of foods, textiles, drugs, and a number of other products have been standardized to a high degree. In the laboratory the fat-content of

milk, for example, has been analyzed, and scores have been set up for judging the quality of milk.

*Grading* means measuring, or comparing, the goods with the standard, and separating or classifying the goods into groups of uniform quality. Then each group, or grade, can be given a symbol or name, so that it can be easily identified. For example, canned fruits and vegetables are sometimes graded as A (Fancy), B (Extra Standard), C (Standard), and D (Substandard).



Consumers' Guide, *U.S. Dept. of Agriculture*

**These two shelves hold ten cans in easily distinguishable sizes. This is an example of what simplification of can sizes can do to make buying easier.**

The standards used for the grades may be determined by the producer himself, by a private standards agency, or by a government agency. These grades are determined by a system of specifications and scoring based on laboratory tests. Here is an example:

POINT SCORE CHART FOR GRADES OF CANNED PEAS

| *Grade* | *Clearness of Liquor* | *Uniformity of Color* | *Absence of Defects* | *Maturity* | *Total Point Score* |
|---|---|---|---|---|---|
| Grade A Fancy | 17–20 | 14–15 | 23–25 | 36–40 | 90–100 |
| Grade B Extra Standard or Choice | 14–16 | 11–13 | 20–22 | 30–35 | 75–89 |
| Grade C Standard | 10–13 | 8–10 | 17–19 | 25–29 | 60–74 |
| Grade D Substandard | 0–9 | 0–7 | 0–16 | 0–24 | 0–59 |

GRADES OF CANNED PEAS

*U.S. Grade A or U.S. Fancy* canned peas are peas surrounded by practically clear liquor; possess a practically uniform typical color; are practically free from breaks and other defects; are very tender; possess a normal flavor; and score not less than 90 points when scored according to the scoring system outlined above.

*U.S. Grade B or U.S. Extra Standard* canned peas are peas surrounded by reasonably clear liquor; possess a reasonably uniform typical color; are reasonably free from defects; are reasonably tender; possess a normal flavor; and score not less than 75 points when scored according to the scoring system outlined above.

*U.S. Grade C or U.S. Standard* canned peas are peas surrounded by liquor which may be cloudy; possess a typical color which may be variable; are fairly free from defects; may be starchy; possess a normal flavor; and score not less than 60 points when scored according to the scoring system outlined above.

*Grade D* canned peas are peas which fail to meet the requirements of U.S. Grade C or U.S. Standard. Canned peas which fall below the Standard of Quality promulgated under the Federal Food, Drug, and Cosmetics Act shall be certified with the additional statement, "Below Standard in Quality," together with the reason for so certifying.

## Informative Labeling

In order to simplify this problem of standardized information, attempts have been made in recent years to provide *informative labels,* that is, labels which give the shopper facts about the goods. These are used in three main forms: (1) *certification labels,* (2) *standardized descriptive labels,* and (3) *grade labels.*

A certification label guarantees that the product complies with certain recognized requirements and tests, without necessarily stating those standards on the label. The problem for the consumer is to learn which certifications are based upon high standards. Among the better-known, reliable certifications are the following: The "UL" (Underwriters Laboratories) label on electrical appliances, the "ASA" (American Standards Association) label on gas appliances, and the "USP" (United States Pharmacopœia) or "NF" (National Formulary) label on drug products.

A more limited type of certification is provided by some commercial organizations. A few retail concerns like R. H. Macy & Co., in New York City, maintain research departments that test products in which they deal. They occasionally pass on to the consumer some of the results of these tests, through certifications in their advertising.

Some magazines test the products that are advertised in their pages. For example, *Good Housekeeping* assures its readers, "Each product

and service advertised in this issue is guaranteed to this extent: If not as advertised herein, it will, upon request and verification of your complaint, be replaced or your money refunded."

Some professional associations, such as the American Medical Association (AMA) and the American Dental Association (ADA), give their "seals of acceptance" to products.

A standardized descriptive label is a standardized point-by-point listing of major characteristics of the product. The informative label sponsored by the National Consumer–Retailer Council answers these questions: (1) What is the product made of? (2) How is it made? (3) How will it perform? (4) How should it be used? (5) How should it be cared for? (6) What is the name and address of the manufacturer and distributor?

In buying a blanket, for example, the consumer would learn from such a label whether the blanket was all-wool or partly-woolen-partly-cotton, and of what material the binding was made. The label would tell also the width and the length, and the weight in ounces per square yard, and would describe the performance by stating the breaking point and by giving information about color-fastness and shrinkage. The label would also give directions for washing and storing the blanket.

Some manufacturers are voluntarily supplying such information on tags or labels attached to their products. Information about the materials used in most types of woolen products is now required by law.

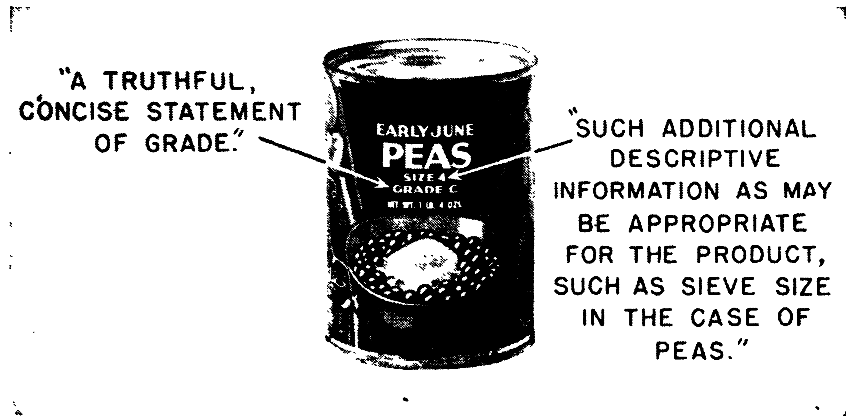
Many people feel, however, that descriptive labeling is not enough, because consumers may not be able to interpret the information given on the labels or tags, and because it does not enable consumers to compare accurately the values of different brands. They believe that descriptive labeling should be combined with actual grading of the products.

A grade label is a symbol, on the product or its container, which summarizes the approximate quality of the product and shows where the product ranks in an established scale. The grade may be expressed by letters (A,B,C), by terms (Fancy, Choice, Standard), by numbers (1, 2, 3), or by a score (100, meaning "perfect"). The grades must be widely known and understood if they are to be valuable to consumers. We have already seen how these grades are determined (see page 135).

### Compulsory and Voluntary Grade Labeling

Although the grading of food is in most cases not compulsory, the federal government has done much to encourage it. The Meat Inspection Act of 1906 merely requires that meats be inspected for wholesomeness, to prevent the sale of meat from diseased animals. Some

packers, however, voluntarily have their meats graded by the Agricultural Marketing Service (AMS) of the Department of Agriculture and stamped as "Prime," "Choice," "Good," "Commercial," and "Utility." The AMS has also established grades for butter, poultry, eggs, and canned fruits and vegetables, which are used by some producers. A producer who uses the government grades and permits government inspectors to watch the canning process continuously, is allowed to print upon the label a special shield of the AMS.




Consumers' Guide

**The Bureau of Agricultural Economics, a division of the United States Department of Agriculture, nominates this as an ideal can label.**

In 1931, the federal government passed the MacNary-Mapes Act, which provides for some compulsory labeling. The Secretary of Agriculture is allowed to establish minimum standards of quality for canned fruits and vegetables; once the minimum standard has been established for a particular fruit or vegetable, goods below that minimum must be labeled "substandard." Limited funds have slowed down the work of establishing and enforcing such grades.

In addition, state governments provide for the compulsory grading of some products sold within the state boundaries. A number of states require the grading of dairy products, eggs, and fresh fruits and vegetables. These grades vary greatly from one state to another. To add to the confusion, every state has its own set of terms. Grade A eggs, for example, are first-grade eggs in five states, second-grade eggs in three other states, and fourth-grade eggs in one state.

Since the 1930's, consumer organizations have been urging the adoption of laws which would require grade-labeling of products, especially canned foods, for these reasons: (1) Consumers would like to buy on the basis of knowledge rather than guesswork. (2) Grade labeling en-

ables consumers to insist on lower prices for lower quality. (3) Large business firms, government agencies, and large private institutions buy goods on the basis of quality specifications, rather than by brands, and therefore get maximum value per dollar, but the ordinary consumer has to rely on the limited knowledge that he can acquire in the ordinary shopping process.

The campaigners for grade labeling point to Canada, where compulsory grade labeling has been in effect since the early 1930's. Contrary to the argument of its opponents, the grading system has not eliminated brand names and advertising; at the same time producers are protected against unfair competition from producers of inferior merchandise. Many American firms sell their packaged goods in Canada, although their shipments to Canada must be graded. In the opinion of these people, grade labeling benefits both consumers and businessmen alike. Among the staunchest advocates of grade labeling are a number of large business firms, many of them working in coöperation with the National Consumer–Retailer Council.

The opponents of grade labeling say grade labeling shows lack of faith in the intelligence of the American housewife. In their opinion, the average housewife has proved herself an expert in getting her money's worth and needs no such help as grade labeling. Brand names help her to distinguish better products from inferior ones. Grade labeling would regiment products, reducing them all to the lowest score within any grade, and would destroy the incentive to produce better products. Such regimentation, it is claimed, would be a blow to free enterprise.

## Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| certification label | informative label | standardized descriptive label |
| grade label | standard | |
| grading | standardization | |

II Questions and Problems

1) (a) In what ways has the lack of standards for consumers' goods created problems? (Consult Lesson 13 for further material.) (b) Why might consumers object to increased standardization?
2) (a) How are our methods of production based on standardization? (b) How could standardization be applied in consumer buying?
3) "There is as much justification for compulsory grade labeling as there is for enforcing uniform weights and measures." Give your opinion of this statement, with your reasons.

4) Show how standardization or grade labeling may affect you with regard to (a) health or safety, (b) convenience, (c) economizing, (d) freedom of choice.
5) "With consumers growing more price- and quality-conscious the heyday of national brands is threatened," wrote a financial columnist. (a) To what extent is this a sound prophecy? (b) Would you consider it desirable to minimize brand names and replace them by grade labels? Why or why not?
6) Compare in column form the value of each of the following forms of consumer information: (a) reports or certificates of approval by magazines, (b) reports by consumer-owned testing agencies, (c) informative labeling by manufacturers, (d) grade labels based on government standards.

III THINGS TO DO

1) Write to National Consumer-Retailer Council (8 W. 40 St., New York, N.Y.), and to the U.S. Inspected Foods Educational Service (745 Fifth Ave., New York, N.Y.), for their literature. Write a report about the activities of these organizations.
2) Write to the National Canners Association (Washington, D.C.) for their literature. How do their recommendations differ from those of the two organizations mentioned in the previous question?
3) Bring to class a variety of labels. (a) Compare them as to their usefulness to the consumer, and (b) classify them, using the types defined in this lesson.
4) Debate the question: "Resolved that Congress should pass a law for compulsory grade labeling of canned foods."
5) Read the following pamphlets: (a) *Read Your Labels* (Public Affairs Pamphlet No. 51). (b) *Using Standards and Labels* (Consumer Education Series No. 6, National Association of Secondary School Principals, 1945).

# *LESSON 19* CHECKING HARMFUL PRACTICES

## LET THE BUYER BEWARE!

For many centuries our law upheld the principle that when a person bought an article, he did so at his own risk. If he bought a pair of shoes that proved to be made of paper, or a "cure-all" that cured nothing, it was his loss. It was his responsibility to know what he was buying before he bought it. The law said, "Caveat emptor," a Latin phrase meaning "Let the buyer beware!"

In our modern economic system, in which the consumer has to buy a countless number of articles and services, such a rule would place the consumer at the mercy of the businessman. There are numerous situations in which a proper regard for the health, safety, and general wel-

Consumers' Guide, *U.S. Dept. of Agriculture*

**A weights and measures official of a local government checks a butcher's scales. Note the standard weights being used. Incorrect scales may be confiscated, and fines imposed on the merchant.**

fare of the community requires that the government step in and say to the businessman, "This you may not do." And so our governments have gradually modified the ancient rule of "caveat emptor." A whole series of laws have been written by the federal, state, and local governments to protect the consumer against dangerous and harmful products, and against frauds, misrepresentations, and deceptions of assorted varieties.

### State and Local Legislation

Health departments assure us of pure milk by inspecting the cows, regulating the sanitary conditions on the farms, and supervising the pasteurizing and bottling of milk. Food stores and restaurants are strictly regulated by health and market departments as to space, storage, ventilation, cleanliness, refrigeration, washing facilities, and the health and clothing of employees. Some states have established standards of quality for foods and other products which spoil easily; such as, meats, eggs, fresh fruits and vegetables, seeds, fertilizers, preserves, and salad dressings. Perhaps the most widespread form of consumer protection is the inspection of scales in order to prevent short-weight practices.

### How Federal Regulation Began

Until the twentieth century, protecting the consumer was left almost entirely to the state and local governments. In 1906, however, the nation was shocked when Upton Sinclair, in his book *The Jungle*, exposed the filthy conditions which existed in the meat-packing plants of those days. Largely as a result of this exposure, Congress passed the Meat Inspection Act, requiring that all meat shipped in interstate commerce must be inspected and tagged by the inspectors of the Department of Agriculture, to prevent the sale of meat from diseased animals. This inspection and tagging, or stamping, of meat, guarantees only its purity, and should not be confused with "grading" of meat for quality, which was discussed in the previous lesson. The law was a great victory for American consumers, and it led eventually to the construction of modernized, sanitary meat-packing plants.

The same year, the basic Pure Food and Drug Act was passed, climaxing a movement led by Dr. Harvey Wiley. This law forbade misbranding or adulteration of foods and drugs shipped in interstate commerce.

The term *adulteration* is applied in the following cases:

1. The product contains poisonous or injurious ingredients, or preservatives which are not mentioned on the label or package.
2. Inferior ingredients have been used, so that the product is below the strength or quality set by official standards.
3. The product is partly or wholly decomposed (rotten).
4. The product has been colored or powdered to hide spoiling or to appear better than it really is.

In all these cases the product contains some inferior, harmful, or undesirable substance.

The term *misbranding* is applied in the following cases:

1. The ingredients, or the weight or measure of the contents, are not clearly stated on the label or package.
2. The package has been labeled or branded (named) to deceive the purchaser—a well-known brand has been imitated, or false claims made that the product has been imported from a foreign country.
3. False or misleading statements about the quality or use of the product are made on the label or package.
4. The contents of the package have been partly or wholly removed and other products substituted, without any indication on the label or package that such a change has been made.

In all these cases it is the label or package that misrepresents the product. Misrepresentation through advertising is not included as a form of misbranding.

### Consumer Legislation of the 1930's

The basic pure-food and drug law, though very important, had a number of weaknesses. By the 1930's the need for better protection of the consumer was apparent. During the boom of the 1920's, the American people had been flooded with thousands of new patent medicines, cosmetics, and canned foods. Newspaper, magazine, and radio advertising had been developed to publicize these products. It became harder and harder for the consumer to know what he was really buying and how much it was worth. Because of the opposition of manufacturers, newspapers, and advertising agencies, however, it took a half-dozen years to get the reform legislation through Congress. Finally, three important laws were passed: the Food, Drug, and Cosmetics Act of 1938 (amending the Pure Food and Drug Act of 1906), the Wheeler-Lea Act of 1938 (amending the Federal Trade Commission Act of 1914), and the Wool Products Labeling Act of 1939.

The Food, Drug, and Cosmetics Act made a number of improvements in the old law, among which are the following major items:

1. Cosmetics, except soaps, now come under regulations similar to those for foods and drugs.
2. The government no longer has to prove the producer's deliberate intent to deceive the public, as it previously had to do. Misbranding or adulteration is in itself sufficient cause for punishment.
3. The sale of drugs or cosmetics which are dangerous when used according to the directions given on the label or package is prohibited.
4. New drugs may be sold only after they have been approved by the Federal Security Administrator.
5. Labels on packages of drugs must be written in easily understood English and must warn the buyer if the drug is habit-forming or likely to deteriorate.
6. The Food and Drug Administration is given the power to establish

standards of identity and quality for many foods; the chief exceptions are fresh and dried fruits and vegetables. A *standard of identity* is a list of the characteristics which a product must have in order to be called by a particular name, for example, the name "aspirin" or "jelly." A *standard of quality* refers to the establishment of grades for the product.

7. The government has the right to inspect establishments producing foods, drugs, and cosmetics for interstate commerce.

8. The use of *deceptive containers* is prohibited. The term "deceptive containers," or "deceptive packaging," refers to the use of containers which give a false impression of the amount they contain, because of false bottoms, extra-thick sides, or slack filling.

9. Several types of penalties are provided. The adulterated or misbranded goods may be confiscated by the government. Fines up to $10,000 may be imposed, or imprisonment up to three years. The Food and Drug Administration may apply to the court for an *injunction* (restraining order) to prohibit a business firm from carrying on any activities in violation of the Act.[1]

Since 1914 the Federal Trade Commission (FTC) had tried to curb false advertising under the laws regarding *unfair trade practices.* The Commission could not act directly to protect the consumer, but rather could act to protect businessmen against dishonest competition. The Wheeler-Lea Act of 1938 gave the Commission the responsibility of protecting the consumer against *false advertising* of foods, drugs, and cosmetics. The term "false advertising" is defined to include not only the making of false statements, but also the omission of important facts about the product. Fines up to $10,000 and imprisonment are provided as penalties.

The Wool Products Labeling Act requires that for any product containing more than 5% wool, except carpets, rugs, mats, or upholsteries, the following information must be given in simple language, clearly printed: (1) the percentages of new (virgin) wool, of reprocessed (rewoven without having been worn) wool, of reused (worn or used) wool, of non-wool fibers (rayon, cotton, etc.), and of weighting or filling material; and (2) the name of the manufacturer and/or seller.

### The Effectiveness of Consumer Legislation

The importance of these laws is well illustrated by the news releases of the Federal Trade Commission and the "Notices of Judgment" of the Food and Drug Administration. Typical cases handled by the FTC have dealt with the following:

Medicinal tablets advertised as a cure for hardening of the arteries, neuralgia, kidney stones, and acidosis

---

[1] Twelve states have similar laws regulating intrastate trade in foods, drugs, and cosmetics. These states are Connecticut, Florida, Indiana, Louisiana, Missouri, Nevada, New Jersey, New York, North Carolina, Tennessee, Virginia, and Washington. The other states have less far-reaching food and drug laws.

Rayon sold as silk, synthetic pearls as genuine pearls, and leatherette as leather

Eye drops advertised as a cure for all diseases of the eye

A hat made of used materials sold as new

A wholesaler advertising himself as a manufacturer, and a retailer pretending to sell at "wholesale" prices

A "waterproof" paste for walls and floors, and a hair tonic that would "grow" hair, and cosmetics that would keep the complexion young

Domestic products advertised as "English"

A correspondence school which "guarantees" civil-service jobs to its graduates

The following are examples of products involved in cases handled by the Food and Drug Administration:

Hair dyes containing poisonous ingredients

A medicine containing a habit-forming drug, with no warning on the label

Tomato juice which failed to meet the standards of identity and quality

Ice cream cones, flour, candy, and butter—adulterated, contained decomposed substances

Fresh apples which were adulterated with an excessive amount of lead

Sugar-cane syrup which contained no sugar and whose label did not reveal that the syrup contained artificial coloring

Coffee misbranded, since the package contained less than the "1 lb." printed on the label

Grapefruit juice labeled "Grade A" when it was not Grade A

Bandage-roll packaged in excessively large package, giving a false impression of quantity

Radioactive water, dangerous to use under any circumstances

A great deal of protection is being given to the consumer. Many people who have studied the situation feel, however, that the efforts of the government agencies fall far short of the need. There are several reasons for the limited effectiveness of our present consumer laws.

First, the federal laws do not cover the large amount of business in food and drug products which is local, rather than interstate. In some states there is fairly strict regulation; in the majority of states, however, the activities for the protection of the consumer are inadequate. Second, there are still many loopholes in the laws. Third, neither the federal nor the state agencies established for the protection of the consumer have had sufficient funds to do all the work needed. Fourth, the procedures of enforcement are very slow. It takes many months, sometimes several years, for a case to be completed. Fifth, the penalties are light. Usually they involve merely the confiscation of the defective goods, or a fine of a few hundred dollars, or, in the case of false advertising, a cease-and-desist (stop) order. Finally, the enforcement of the laws is scattered among numerous agencies. This makes a strong, unified enforcement policy difficult.

The complaint has been made that the public is not sufficiently aroused about the work of the consumer agencies of the government and that some businessmen can violate the laws with little fear of complaint by consumers. Apparently the people of this country are not "consumer-conscious."

It has been proposed that a Department for Consumers be set up in the federal government. This would parallel the Departments of Commerce, Labor, and Agriculture. Its first step would be to bring together in one agency much of the work done now for the consumer in a number of scattered governmental agencies, so that their work would be coördinated and the consumer would know exactly where to turn for aid and information. Among the specific services that have been suggested for such a department are the following:

1. To speak for the consumer in regard to pending legislation
2. To engage in research, making available statistics and other forms of consumer information
3. To issue periodicals and special bulletins and to conduct radio programs for consumers
4. To have an adequate inspection service for checking on the production and sale of consumer goods
5. To test and rate products on a nation-wide scale, in the manner now done by the consumer-owned rating services and by one state

Similar improvements have been urged in the services rendered by the state and local governments. Businessmen have objected to such sweeping consumer legislation as dangerous to our system of free enterprise. In their opinion, the consumer is best protected by the self-regulation of business practices and competition among businessmen.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| adulteration | false advertising | standard of identity |
| caveat emptor | misbranding | standard of quality |
| deceptive packaging | | |

### II Questions and Problems

1) (a) Explain what is meant by "caveat emptor." (b) What would be the meaning of "caveat venditor"? (c) To what extent is either of these two sayings a good principle to follow?
2) (a) Explain the conditions which led to federal legislation to assist consumers. (b) Why was consumer legislation less necessary 100 years ago?
3) State the important provisions of each of the following: (a) Meat

Inspection Act, (b) Pure Food and Drug Act of 1906, (c) Food, Drug, and Cosmetic Act of 1938, (d) Wheeler-Lea Amendment to the Federal Trade Commission Act.

4) Explain how local and state governments assist consumers.
5) (a) List five services now performed by the federal government for consumers which might become the responsibilities of a "Department of the Consumer." (b) State the possible advantages and disadvantages of such a federal department.
6) Choose three of the weaknesses of the original Pure Food and Drug Act and show the extent to which these weaknesses were overcome by the revised act.
7) Write an editorial, or a letter supposedly to a newspaper editor, expressing your approval or disapproval of one of the following: (a) a federal department of the consumer, (b) increased appropriations for the administration of federal food, drug, and cosmetic laws, (c) expanding the federal label laws to apply to clothing and household appliances.
8) The Federal Trade Commission was formed originally to prevent unfair competition among businessmen. (a) How may unfair methods of competing with a rival business cause unfairness to consumers? (b) How has the FTC become an agency for the protection of consumers as well as of businessmen?

III Things To Do

1) Report to the class on the provisions of local laws pertaining to consumer protection. (For example, an interview with a restaurant or barber-shop proprietor may be a source of information.)
2) Examine a Federal Trade Commission news release, and "Notices of Judgment" published by the Food and Drug Administration. Report to the class on your findings.
3) Report on the life and accomplishments of Harvey Wiley.
4) Report, using history books as reference, on the work of the "muckrakers." How did they contribute to the passage of consumer legislation?
5) Read *The Jungle* by Upton Sinclair (Vanguard).

# *LESSON* 20 CONSUMERS' COÖPERATIVES

## Junior Coöperatives

"At Centerville, Minnesota, a group of students, dissatisfied with the quality of notebooks they were buying, asked the teacher if they could have a store of their own. A thorough study was made. A store was in-

corporated; shares were sold. One boy was selected as manager. Shelves were built and decorated. Stock consisted of tablets, pencils, erasers, notepaper, cough drops, paper towels, and soap."

This quotation describes the Centerville school store, one of the many coöperative projects reported in *A Handbook for Junior Coöperatives,* published by The Coöperative League of the U.S.A. When the students of Centerville decided to organize their store on a coöperative basis, they followed a plan that differed in some fundamental respects from ordinary business.

Like any other business firm, they had to obtain money for equipment and stocks of supplies. This they did by selling shares to any student who wished to become a member of the enterprise, and not merely to a select group of investors, as would be the case in the ordinary small business. Open membership was the goal. In order to encourage widespread membership, shares were priced very low. The investors received interest on their investment, but at a low rate. The reason for this is that a coöperative is run primarily for the benefit of the consumer and not as a means of making profits for the owner or investor.

This consumer-domination appears most clearly in the way the earnings or savings of the business are shared. In the ordinary type of business, profits are divided, in the form of dividends, among the investors in proportion to the number of shares they own. In the coöperative, profits are divided among the members in proportion to their respective purchases, in the form of *patronage dividends.* A Centerville student who during the year bought $10 worth of supplies would get ten times as large a dividend as another student who bought only $1 worth. These returns to the member-customers are considered savings rather than profits as in the usual type of business.

The Centerville school store, like any other business, had to be managed. The students selected one of their group as manager. They might have hired outside help instead of, or in addition to, this member-manager. Over and above hired managers, clerks, and other employees, were the consumer-members themselves. At their regular meetings they decided major matters of policy, such as whether to engage paid help, and whether to distribute the savings among the consumer-shareholders or to reinvest all or some of it in the business. In making these decisions, each member had one vote, no matter how many shares he owned. This method of voting is in contrast with the method of voting in a corporation, in which each stockholder is entitled to one vote for each share that he owns. Equality of voting prevents wealthy investors from taking over control of the organization.

THE STORY OF TOAD LANE

The ideas and policies of the *consumers' coöperative* had a long history before they were taken over by the Centerville school store. The coöperative method had been tried many times and in many variations, but it was not until the year 1844 that a successful formula was hit upon. "In 1844, Toad Lane in the city of Rochdale, England, was just about as unappetizing as its name. It was dark, grimy and lined with warehouses. But from this black soil was to spring a plan that has since flowered all around the world."[1]

The workers in Rochdale were miserably poor. Unable to improve their sad condition through wage increases, a few of them decided to make ends meet by lowering the cost of living. This was to be done by eliminating as far as possible the profit going to the *middlemen* (see p. 160) on goods bought for consumption. These consumers of Toad Lane were to become their own grocers and shopkeepers, and after a while, they dreamed, they would be their own clothing manufacturers and shipowners and bankers.

So in the winter of 1844, twenty-eight of these workers scraped together a few dollars apiece, rented a little store, and stocked it up with a small supply of flour, butter, sugar, and oatmeal. From then on, when they bought any of these goods they were buying from themselves, and the savings, if any, were theirs. The little store in Toad Lane prospered, and when it celebrated its 100th anniversary in 1944, it was in the big-business class. By that time it had become the model for similar enterprises throughout the world. And the city of Rochdale had given its name to the world-wide Consumers' Coöperative Movement.

The Rochdale Society of Equitable Pioneers, as it was appropriately called, worked out the set of rules that we saw in operation at Centerville, and that operate in innumerable Centervilles all over the world. Here are the *Rochdale principles:*

1. Open membership. Anyone may join. Shares are usually low priced, about five dollars on the average, in order to encourage widespread membership. (The typical consumers' coöperative has between 100 and 250 members.)
2. One person, one vote. This provides for democratic control.
3. Savings returned to members on the basis of patronage.
4. Limited (small) interest on shares.

In addition to these major principles there are several secondary ones:

5. Goods are sold for cash only.
6. Goods are sold at current, or prevailing, market prices.

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[1] Stuart Chase, *The Story of Toad Lane*, published as a pamphlet by The Coöperative League, 157 West 12 Street, New York 11, N.Y.

7. The coöperative should spend some of its savings on constant education in the principles of coöperation.

A consumers' coöperative is, in brief, a business enterprise operated by consumers for the purpose of securing commodities or services at lower cost by eliminating some of the profit of the middlemen.

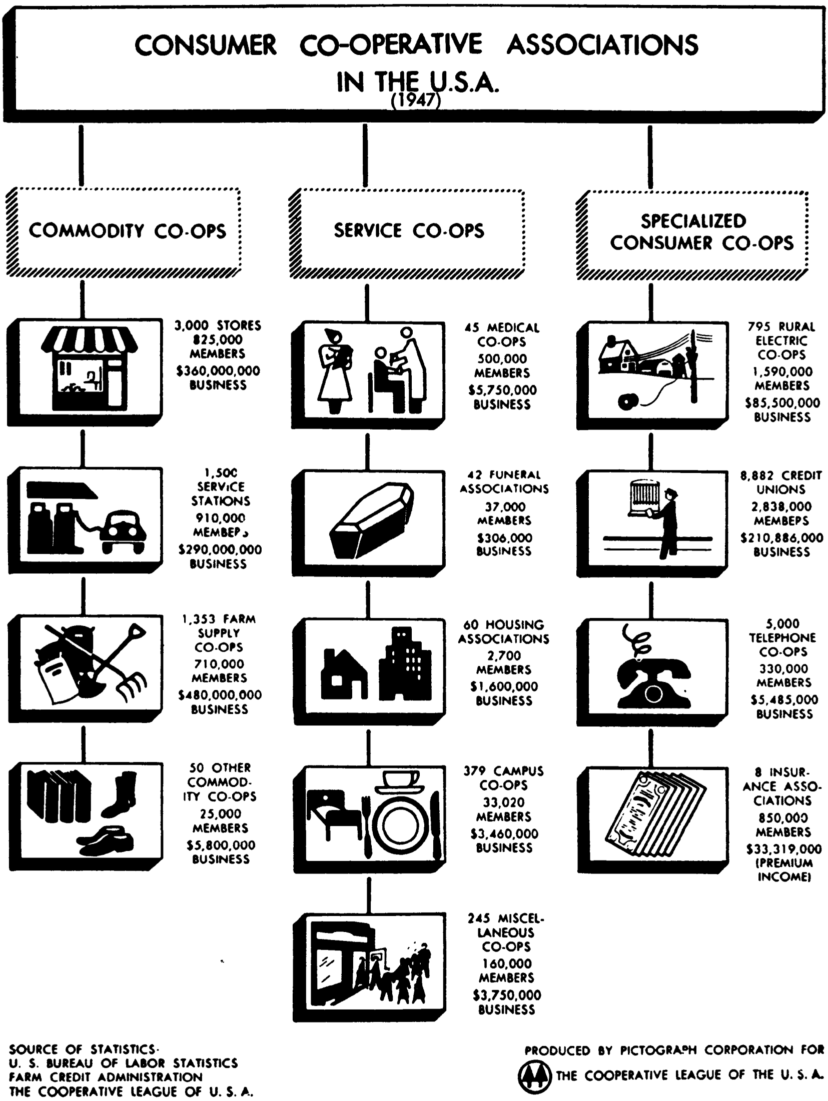
### Development of Coöperatives

The coöperative movement has spread throughout the world. The little Rochdale Society of 1844 has developed into the Coöperative Union of Great Britain with its own wholesale departments, slaughter-houses, banks, and tea plantations—to mention only a few of their many undertakings. Scandinavians have taken to the idea with great zeal; Sweden's coöperatives have made her name synonymous with the "Middle Way" between capitalism and socialism, and Finland in recent years did as much as 40 percent of its business through coöperatives. Coöperatives of all nations are united through the International Coöperative Alliance.

The people in the United States have been comparatively slow in adopting the consumers' coöperative. There are a number of possible reasons for this. One is our individualism. Because the United States has been a relatively new country, with rich resources, we have tended to believe that every man should take care of himself. In contrast, a larger proportion of Europeans believe in the importance of group action in bringing a better life to the individual. Second, it is a little more difficult to organize permanent coöperatives here because our people have moved from place to place relatively more often than the people in long-established communities of Europe. Finally, business developments in this country have made consumer coöperatives a less immediate need. The efficiency of mass distribution through chain stores and mail-order houses brings savings to many communities, and the popularization of brand names through advertising makes it difficult for a coöperative to enter the field with a coöperative label.

In recent years, however, coöperatives have had a great spurt of energy in the United States. This is due, at least in part, to the aid and encouragement given by the government through financial assistance to farmers' coöperatives and through educational campaigns. The severe depression after 1929 caused many people to turn to coöperatives as a means of saving money.

There are now thousands of consumers' coöperatives of various kinds, with membership in the millions, and sales well over a billion dollars. Farmers bought one-sixth of all their supplies through coöperatives. In the gas and oil business of the Midwest, coöperatives have flourished;




This chart classifies and gives data regarding consumers' coöperatives in the United States. The largest number of coöps were credit unions; the largest volume of sales was made by those supplying farmers. Their total business, however, was a tiny proportion of total business in the country.

over 2000 engage in drilling, pipe-line transportation, refining, and the operation of service stations. There are apartment houses that are coöperatively owned by the tenants. *Credit unions* are coöperative loan associations in which the members provide the funds from which they

can borrow, at a low rate of interest, in time of need. We also have coöperatives for insurance, for medical care, and for burial expenses. On college campuses and in high schools there are over 300 coöperatives serving student needs for bookstores and cafeterias.

The coöps, as they are popularly called, have organized on a country-wide scale through National Coöperatives, Inc., and The Coöperative League, with branch offices in New York, Chicago, and Washington, D.C. Through their national and regional affiliations they assist one another financially and engage in educational activities. They produce some of the goods they sell. They have their own wholesale organizations to supply the retail coöps with goods. They also protect and popularize the coöperative emblem and the principles for which it stands.

This is the coöp trademark. Coöps also handle brands of other producers.

Only enterprises authorized to carry this emblem are real consumers' coöperatives. They should be distinguished from *marketing coöperatives,* and so-called coöperative apartments, which are not generally operated on Rochdale principles. (See page 430.)

EVALUATION

The purpose of the coöperative is to help consumers lower their cost of living. The success of a coöperative depends partly upon whether local competing enterprises are charging unreasonable prices, and partly on its own efficiency and economical operation. A major argument of the coöperatives is that, by and large, in their enterprises quality is higher than elsewhere. Grade labels are used whenever possible. Since they sell to themselves, coöperators are not tempted to misrepresent quality or quantity.

There is considerable difference of opinion within the movement itself as to whether coöperatives constitute a threat to the capitalistic system. The more conservative element says that America has room for many different types of business, and that the coöp is one good way of doing business. It is particularly useful as a method of combating

monopolies, as has been proved in Sweden and in the Midwestern gasoline coöps. Some reformers look upon the coöperative not merely as a means of helping the consumer get more for his money, but as a new economic system that can help solve the problems of poverty and depression in the capitalist system.

Finally, the idealists among coöperators, whether extremist or conservative, claim that one of the major results of the movement is the strengthening of American democracy. People are given a chance to express themselves and to share in the management of something that affects their daily lives; the ownership of business is put in the hands of the common man. The very idea of coöperation, they insist, is thoroughly American, and they point to the various forms of coöperation which were practiced in the communities of the pioneers who built this country.

Opponents of coöperatives claim that they are inefficient and wasteful of human effort. Many a coöperative has gone out of business as an inevitable consequence of inadequate capital or bad management. We cannot always expect consumers to prove efficient as business managers. In those cases where consumers work in their own coöp as clerks without any compensation, they should realize that the real cost of doing business is greater than what they pay for their merchandise; it involves also a sacrifice of the consumers' leisure time.

Some people oppose the very idea of coöperatives. To some extent businessmen fear their competition and ask what will happen to those thrown out of business or employment by coöps. A good deal of the controversy concerns the matter of taxation. Some critics claim that coöperatives are favored by special tax exemptions which give them an unfair competitive advantage. It is argued, finally, that the coöperative system really represents a threat to the capitalist, or free-enterprise, system.

Whatever our opinion of the value of the coöperative movement, we must recognize it as an important device in the many attempts to solve the problems of the consumer.

## Exercises and Activities

I Dictionary of Economic Terms

| | |
|---|---|
| consumers' coöperative | patronage dividend |
| credit union | Rochdale principles |

II Questions and Problems

1) In parallel columns compare a consumers' coöperative store with the usual type of retail store with respect to: (a) its aim, (b) how it

gets its capital, (c) to whom it sells, (d) how its policies are decided, (e) how its earnings or profits are divided.

2) (a) Explain the possible advantages of membership in a consumers' coöperative. (b) Explain why there is no gain in owning more than one share of a coöperative. (c) What reasons may one who is not a member of a consumers' coöperative give for buying from the coöperative?
3) Summarize the arguments a businessman might give against coöperatives.
4) Summarize the Rochdale principles.
5) In what ways can a coöperative help its members to solve any of the consumer problems discussed in Lessons 13–20?
6) What problems would have to be solved in order to have an efficiently operating coöperative grocery in your community?
7) Explain why the establishment of consumer coöperatives has been slower in the United States than in foreign countries.
8) Outline the steps that would have to be taken if a coöperative store were to be organized by your student-government body.

## III Things To Do

1) Is there a consumers' coöperative in your community? If so, visit it and report to the class on your observations.
2) Write a report on taxation of coöperatives. Material on both sides of the controversy may be obtained from the National Coöperatives, Inc., and the National Tax Equality Association, both in Chicago.
3) Read (a) *Coöperatives*, Headline Books, by R. A. Goslin (Foreign Policy Assn., New York, 1937). (b) *Coöperatives in the U.S.—A Balance Sheet* by Maxwell S. Stewart (Public Affairs Pamphlet No. 32, 1944 Revised Edition). (c) *Organization and Management of Consumers' Coöperatives and Buying Clubs* (Superintendent of Documents, Government Printing Office, Washington, D.C., 1941).

# *UNIT* 5

## OPERATIONS OF BUSINESS

*21* BUSINESS ENTERPRISE
*22* BUSINESS INCORPORATION
*23* CORPORATION MANAGEMENT AND FINANCE
*24* SELLING SECURITIES
*25* INVESTMENT AND SPECULATION
*26* THE BUSINESSMAN AND HIS BANK
*27* BUSINESS ASSETS AND BUSINESS FUNDS
*28* FINANCIAL STATEMENTS

# LESSON 21 BUSINESS ENTERPRISE

## Organizing the Factors of Production

Grocery, drug, clothing, appliance, and a host of other stores; flour mills; steel plants; dairies; farms; railroads; brokers' offices; banks; insurance companies—all are examples of *business enterprises.* Together with some publicly operated enterprises, like the post office or a local housing project, they produce the goods and services which make up the national product. In turn, the money they pay out for labor and materials is used in buying goods and services.

Each business enterprise (establishment, concern, firm, or company) produces a commodity or service which it sells for money. Each pays money for the space, machines, materials, labor and other services required. The amounts taken in are its income; the amounts paid out are its *costs of production.* When income is greater than costs, the business has a profit. Businessmen undertake the risks and responsibility of starting and operating business enterprises because they hope to make profits.

To start a business enterprise, the businessman must gather the goods and services needed for production. Land, machines, materials, labor, or any other commodity or service which contributes to the production process is called a *factor of production.* The building of a house requires a plot of land, lumber, nails, bricks, cement, or other materials, and a variety of labor, from the technical skill of the architect or engineer to the work of the unskilled day laborer; each of these is a factor of production. The factors of production used in all enterprises are numerous, and it is convenient to classify them under the headings of *land, capital,* and *labor.* "Land" means any commodity or service contributed by nature—the building site, the vein of coal in a coal mine, the waterfall in an electric-power plant are examples. "Capital" means any produced good used for further production. It includes the tools, machines, buildings, and materials used in the production process. "Labor" means all human effort used to produce goods and services. This includes mental as well as manual labor. Sometimes the special kind of labor contributed by the businessman who gathers, combines, and directs all the other factors is separately classified as a fourth factor called *management.*

The payments made by a business enterprise for the factors of pro-

duction are its costs of production. In order to keep costs as low as possible, the businessman must combine the necessary factors in the proper proportions. This is referred to as the *principle of proportioning of factors.* The grocery-store owner, for example, must decide whether to use two or three clerks in his store. More help with a given store area means faster service and may therefore attract more customers. The question is whether the expenditure for extra labor will increase business enough to give the owner added profit. This type of problem is characteristic of all kinds of businesses.

In putting together the factors of production, businessmen will tend to make more use of the cheaper factors. In large cities, where rents tend to be high, it pays to construct high buildings, using less land but more capital and labor; this is the reason for skyscrapers. In outlying sections, where land cost is relatively low, buildings will spread horizontally, using more land and less of the other factors. In regions where labor is cheap, labor-saving machinery will not be used so much as in areas where wages are high. In regions of dense population and cheap labor, farmers use less machinery than in regions where land is plentiful and labor more costly. That combination of factors is best which will result in the lowest cost.

Because he performs the functions of gathering, combining, and directing the factors of production, the businessman is sometimes referred to as an *entrepreneur.* This is a French word which expresses the idea that he undertakes to start, operate, and manage a business venture. First, he must conceive an idea for a product or service that will sell. Second, he must investigate the practicality of the idea, the availability and cost of the factors needed, the legal restrictions involved, the amounts of funds that will be required and sources for obtaining them, the demand for the product, the competition that will come from other producers, and other conditions that will affect the chance for profit. Third, he must provide the needed funds from his own savings; and, if his own funds are insufficient, borrow the money, or get others to share in the venture. Fourth, he has to acquire the factors which he needs, select a location, and begin production. Finally, he has to sell the product. Once he has created a "going concern," he has to exercise continuous supervision over the factors of production, see to their proper combination, provide for their replacement, and direct the selling and financial operations of the enterprise. These are the functions of management.

### The Assumption of Risk

The businessman reaps the reward of success in the form of profits; but he assumes the risk of having the business fail and of suffering loss.

Business is risky for a number of reasons. First, demand is changeable and may shrink or disappear. Second, other producers, selling the same type of product, may take away customers. Third, materials, labor, or any other factors of production may become scarce or high in price, as they did during World War II. In that case costs of production may become so high that profits turn into losses. Fourth, an unforeseen event like a fire, a flood, or bad weather, may cause damage or spoil business. The natural hazards of farming are well known; but businesses such as the clothing industry are also affected by the weather. Fifth, our business world is a dynamic one, constantly subject to change. Changes which bring prosperity to one business may ruin others. The extended drought in the Northeast during the early summer of 1949 made business at beach resorts hum, while farmers suffered the agony of watching their crops burn in the sun. New inventions and changing technology may offer opportunities for new business but may destroy established ones. A topic of current interest, for example, is the effect of television upon the motion-picture and radio industries.

The riskiness of business is evidenced in the high rate of business failure, or mortality, especially among new and small businesses. Studies have shown that the chief reason for failure is that many businesses are started without enough funds for efficient operation. A second reason is that the businessman or his managers lack the necessary abilities. The buying for the firm may be inefficient and unskilled, judgments as to demand or prices may be wrong, production may be hindered by poor handling of the labor force, or too much money may be borrowed. Foremost among the abilities necessary for success in business is the ability to get along with people. No matter how informed and expert he may be in other matters, the businessman who cannot inspire confidence in his employees, in his customers, and in the businessmen with whom he has to deal, will find success difficult to attain. A third reason for business failure is bad luck. Fire may destroy merchandise, war may ruin markets or shut off needed supplies, or a new invention may create unbeatable competition.

To summarize, the two main functions of the businessman are (1) to organize and manage the factors of production, and (2) to assume business risks. These functions businessmen perform in order to make a profit.

### The Classification of Industries

A group of related business enterprises is called an *industry*—for example, the steel industry. (The term is also used loosely to mean manufacturing and mining, as distinguished from farming.) Business enterprises may be classified in different ways. We may contrast the

*consumers' goods industries,* which make things for final consumption, with the *producers' goods,* or *capital-goods, industries,* which make goods that are used as factors in further production. We may divide enterprises by the length of time it takes to consume their products. The *durable-goods industries* produce long-lasting articles like automobiles; the *semidurable-goods industries* produce things which do not last so long, like clothing; and the *nondurable-goods industries* produce foods and other commodities which can be used only once. On the basis of the kind of methods used, we can classify some enterprises as *mass-production industries,* because they produce standard goods in quantity, using power machinery; while others, producing individual commodities largely by hand tools, are referred to as *handicraft industries.*

Business enterprises specialize. The clothing factory gets its cotton goods from one firm and its rayons, silks, or woolens from others. Other firms supply thread, machines, buttons, linings. The workers also perform specialized tasks: some design the styles; others cut; still other groups use a variety of specialized machines or finish, sell, pack, or deliver. This subdivision of the production process into specialized branches or skills is known as the *division of labor,* or *specialization.* It breaks up complicated operations into simpler parts, permits the use of machines, and increases the efficiency of production.

The breaking up of the production of a commodity into specialized divisions causes business enterprises to depend upon one another, for the supplies and raw materials of one firm make up the finished product of another, and business enterprises are each other's customers. If we traced the many articles, fixtures, and services found in any large department store back through all the firms contributing to their production, the length and variety of the list of enterprises would show clearly the coöperative nature of modern business enterprise. Production is the result of the coöperative efforts of land, labor, capital, and management in many related business enterprises.

The diagram on page 161 gives a classification of industries according to the product and type of work done. The arrows indicate the interdependence of the groups. The *extractive industries*—farming, fishing, forestry, mining—take or extract from the earth the wealth it offers. The *processing industries*—manufacturing and construction—use the raw materials of the extractive industries, and the products and services of other industries, to create usable goods. The *service industries* provide consumers and business enterprises with services, such as transportation, communication, storage, loans, insurance, advertising, selling, and legal and accounting services.

The businessmen in the service industries are often called *middle-*

*men,* because they stand between the producer of goods and the consumer. *Retailers* sell goods, such as groceries and clothing, and services, such as tailoring and radio repairing, to consumers who use the goods and services directly and finally. *Wholesalers* are middlemen who buy in large quantities from producers and sell in smaller quantities to re-

**THE PRODUCTIVE SYSTEM**

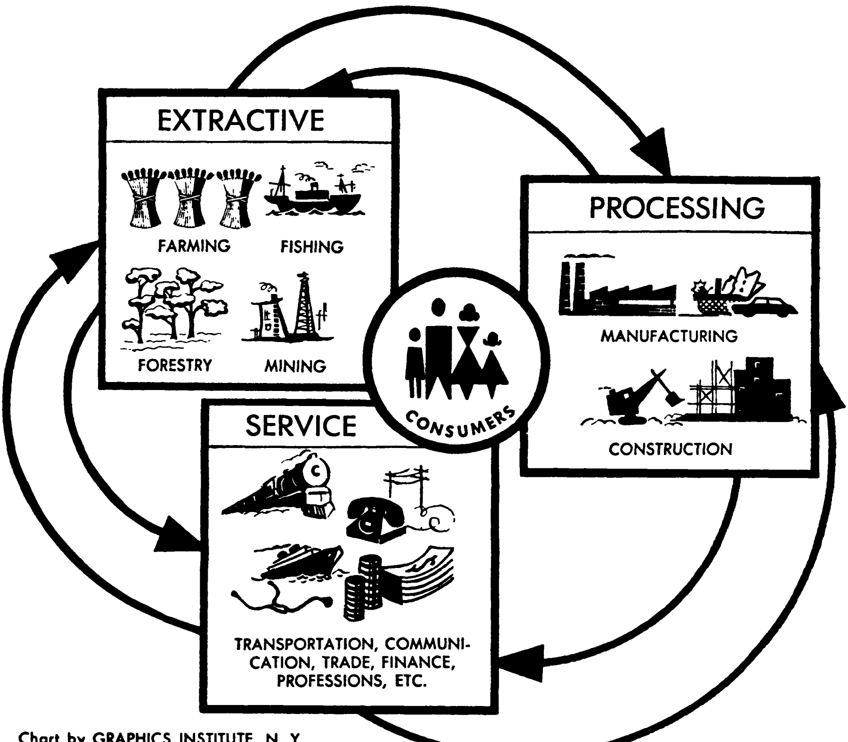


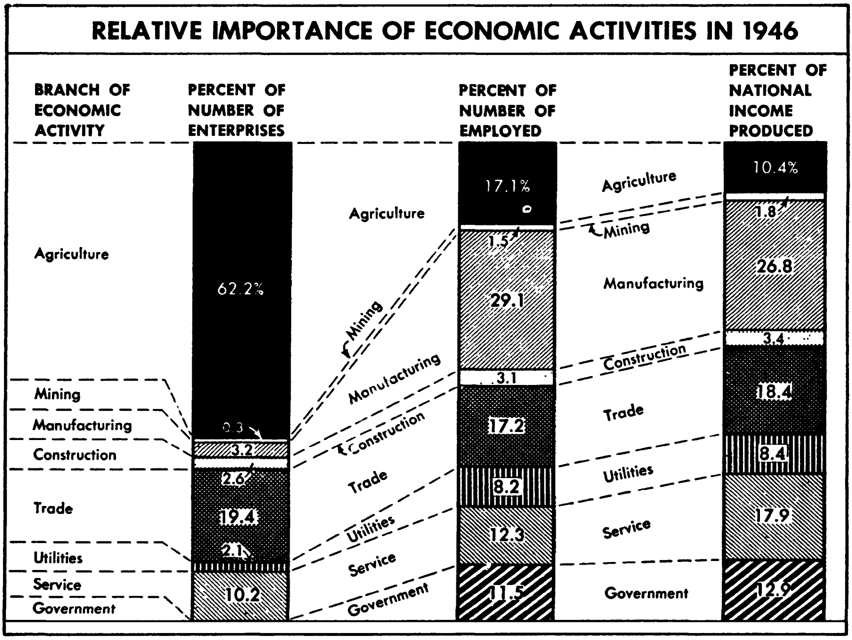

Chart by GRAPHICS INSTITUTE, N. Y.

**This shows the interrelationship of different types of business enterprise. The extractive industries provide raw materials for both processing and service industries. The processing industries provide manufactures and construction for extractive and service industries. The service industries serve all types of industry. All serve the consumer, directly or indirectly.**

tailers, or to smaller wholesalers (jobbers), who in turn sell to retailers. Middlemen bring together, in the large quantities required by manufacturing industries, the products of millions of small, individual firms. They disperse among the millions of individual consumers the large outputs of manufacturers, present the goods in attractive fashion, and make their purchase convenient. The middlemen—wholesalers and re-

tailers—by exercising informed judgment in the buying of goods from producers, furnish buying aid to the average consumer.

The function of the middleman is not confined to trade. The savings bank, for example, receives small deposits from many individuals and is thereby able to make large loans to those wishing to build homes and other buildings. The insurance company uses the premiums of its thou-




**This compares industries by showing three 100% bars. Follow each division, using the dotted lines as guides. Thus agriculture had 62.2% of the enterprises, employed 17.1% of the total workers, and produced 10.4% of the national income. (Data from U.S. Depts. of Labor and Commerce)**

sands of policyholders to invest in large enterprises. Railroads, grain elevators, and stock and commodity exchanges are also examples of businesses which serve as middlemen.

### The Size and Importance of Industry

The graph on this page shows how American industries in 1946 compared with one another as to number of enterprises, number employed, and contribution to the national income for that year. The number of enterprises is greatest in agriculture, trade, and service industries. These three are the strongholds of small business firms; together they account for almost nine-tenths of the number of businesses. But they employ less than half of the nation's workers, and produce less than half of the

national income. Manufacturing, with only about 3 percent of the number of enterprises, employs about 30 percent of the employees and produces about 27 percent of the national income. Here, and in the *utilities* (electricity, gas, transportation, telephone, telegraph), are found most of our giant firms. Of interest is the relative importance of government, employing over 11 percent of all workers, and producing nearly 13 percent of the national income.

To conclude, however, on the basis of such statistical facts, that any low-ranking industry is not essential, would be an error. Mining is a good example. Mining enterprises, in 1946, were only three-tenths of one percent of the total; they employed the lowest proportion of workers, one and one-half percent; and they accounted for less than two percent of the national income. But, since mining enterprises produce coal, oil, iron, gold, and the many other minerals so essential to our way of life, they rank high in importance to our national and individual welfare.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| business enterprise | factor of production | processing industries |
| capital | labor | producers' goods |
| capital goods | handicraft industries | proportioning of factors |
| consumers' goods | industry | retailer |
| costs of production | land | service industries |
| division of labor | management | specialization |
| durable goods | mass production | wholesaler |
| entrepreneur | middleman | |
| extractive industries | nondurable goods | |

### II Questions and Problems

1) The businessman combines the factors of production. Explain. Give an example with reference to a particular business.
2) Business involves planning. Explain.
3) State and explain at least three reasons for the riskiness and high mortality rates in business.
4) Why is the riskiness of business a matter of concern to (a) banks, (b) workers, (c) the public?
5) Show how each of the following situations illustrates the principle of proportioning of factors: (a) The work that is done by derricks and tractors in the United States is done by hand labor in many other countries. (b) On Park Avenue in New York City, the wealthy residents live in skyscraper apartment houses, whereas in the Borough of Queens in the same city, most of the wealthy homes are one-

family houses. (c) Farms in Northern and Western Europe are generally smaller than those in Canada and the United States.

6) The head of a large steel company was paid a million dollars a year. What special ability might he have had, to justify such high compensation?
7) Sumner Slichter, a well-known economist, has said, "In a dynamic world, with the future a mystery, it must be true that profits are in substantial degree a matter of luck." Explain this statement and show why you agree or disagree.
8) Give examples to illustrate the great diversity of our business world in regard to (a) products, (b) processes, (c) size.
9) Choose some product and tell how the extractive, processing, and service industries had a hand in bringing it to you.
10) Examine the graph on page 162, showing the size and importance of various industries. (a) Why are the measurements used in this graph to show relative importance proper ones to use? (b) Why is it wrong to judge importance to the nation by these measurements only?

III THINGS TO DO

1) Draw a map of one block in a business section of your community. On the map classify the different types of business enterprise.
2) Consult your local telephone directory, in which businesses are classified in a separate section. (a) Find there three examples of each of the major classifications of industry listed in the lesson. (b) According to the telephone directory, what kinds of business are most numerous? Why?
3) Visit a local factory, and report to the class. (a) Of what industry is this business a part? (b) What evidences did you find of specialization and division of labor? (c) Describe the factors of production, as used in the factory.
5) Read pamphlets, published by the federal government and some state governments, on starting a small business.

# *LESSON* 22 BUSINESS INCORPORATION

## THE MEANING OF INSOLVENCY AND BANKRUPTCY

A businessman must *invest* money, called his "capital,"[1] to start a business enterprise. In addition most businesses buy merchandise and materials on credit, and some may borrow money. Those to whom the

[1] The term "capital," it will be observed, is used in two ways. In the previous lesson, it was used to mean the actual goods used in production, or capital goods. Here it is being used to mean the money, or funds, used in production; that is,

business owes money are its *creditors*. If, for any reason, the business is unable to pay its debts when they come due, it may be described as an *insolvent* business.

Suppose that Sam Copeland opened a shop under the name of Acme Radio Service, to repair and sell radios, television sets, and other electrical appliances. He invested $2000 in capital, which was mostly spent on fixtures and equipment, and bought $8000 worth of sets and appliances on credit from a number of manufacturers. Selling was more difficult than expected, and after several months Copeland had much unsold merchandise and owed many overdue bills. His fixtures, equipment, and merchandise, at the prices he had paid for them, were still worth enough to pay all his debts; but he could not sell them at these prices. Selling everything for whatever it would bring would yield only $5000, and $3000 more was owed to creditors. Copeland's business enterprise was insolvent.

It would be unfair for Copeland to use the $5000 to pay some of his creditors, while the rest received no payment at all. He might announce his condition to all of his creditors, call them together, and by agreement among all, arrange for partial payment. However, he would find it simpler to ask the courts to declare him officially insolvent, or *bankrupt*. The court would supervise the sale of his properties and the distribution of the proceeds among the creditors. This would be a voluntary petition in *bankruptcy*. On the other hand, his creditors, to prevent him from disposing of the properties without paying them, might request the courts to declare Copeland bankrupt and divide his properties among them; this would be an involuntary bankruptcy. Bankruptcy is the legal procedure by which the courts declare a business to be insolvent, arrange for the distribution of the properties to creditors in accordance with their legal claims, and then declare the business to be discharged of any further obligation.

In the example given, the courts would examine Mr. Copeland to be sure that he was not concealing any properties. They would examine the claims of creditors to assure their being proper and legal. They would arrange the claims in order of preference, if any creditors had special claims entitling them to be paid in full before the others. Then the courts would arrange for the public sale of Mr. Copeland's properties and from the proceeds would make payment to the creditors. Let us assume that the properties of the Acme Radio Service brought $5000 in proceeds, after all expenses involved in the proceedings had been paid. If the claims of all creditors were alike, each creditor would receive 62½% of what he was owed. After discharge in bankruptcy, Mr.

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in the sense of "capital funds." This is its most common meaning to businessmen and accountants.

Copeland, if he could raise additional funds, could make a fresh start, in the same business or in a new one.

### The Risk of Unlimited Liability

Suppose, upon court examination in bankruptcy proceedings, it turned out that Copeland owned the house he lived in and an automobile. These had nothing to do with the business, yet they would be included by the court among the properties which could be seized and sold to satisfy the debts owed by the Acme Radio Service to its creditors. Although Mr. Copeland might feel aggrieved because they were personal rather than business property, the court would make no such distinction. The law regards the Acme Radio Service and Samuel Copeland as identical; there is no separation of Copeland, as an individual, from his business enterprise.

The Acme Radio Service, started by Copeland without legal formality, simply by the investment of capital and the beginning of business operations, is an example of a *single proprietorship,* which is an *unincorporated* business owned by one person. Another type of unincorporated business is the ordinary *partnership,* which has two or more owners instead of one. Legally, the single proprietorship and the partnership, as unincorporated businesses, have no existence apart from the owners. The individuals are sued in court for any debts incurred in the course of business operations. Each owner of an unincorporated business is individually and fully responsible for all the debts of the business enterprise. If the business properties are not sufficient, the personal wealth of each owner, including wealth invested in other businesses, can be used to satisfy the creditors. That is the meaning of *unlimited liability.*

In a partnership the risk from unlimited liability is even greater than in the single proprietorship. Each partner has unlimited liability for all the debts of the business, regardless of how large or how small the amount of capital he has invested.

A partnership organization therefore is not likely to attract the investment of individuals who wish to limit their liability to the sums they invest in the business. The business which requires large amounts of capital and must get this capital from many investors must have a form of business organization which makes it possible to limit each investor's liability to the amount invested. The organization of business enterprises as *corporations* provides the solution.

### Limiting Liability Through Incorporation

*Incorporation* is a legal procedure by which a business enterprise is given an identity separate from its owners. In accordance with legal

requirements established by the state, the business enterprise is authorized to carry on specified business activities as if it were a person. This legally created, artificial person is called a "corporation." Its birth certificate is a certificate of incorporation, or *charter*, granted by the state.

When Copeland, Benson, and Anderson decide to incorporate their business as the Acme Radio Service, Incorporated, they have their attorney file an application with the state, setting forth the name of the corporation, the names and addresses of the organizers, the amount of capital the business is authorized to have, the number of shares into which this capital will be divided, and the purposes for which the corporation is formed. Upon payment of required fees or taxes, the state grants a charter to the new legal individual, the corporation named Acme Radio Service, Inc. Copeland, Benson, and Anderson each invests a given amount of money in the corporation in return for shares in its capital. As evidence of ownership of shares, each receives from the corporation a *certificate of stock*. Copeland, Benson, and Anderson have become *stockholders*, each owning a share in the corporation. The corporation, however, stands apart from its stockholders as a separate person; it can be sued in its own name; it can own property; it can buy and sell, and incur debts.

In the case of the Acme Radio Service, there are only three stockholders, Copeland, Benson, and Anderson. To fulfill the legal requirements, these three meet once a year to elect themselves as directors and officers of the corporation. They are not only the owners of the corporation, but also its employees. They do the same work as if the business were unincorporated, but they now act in the name of the corporation. To the casual observer the Acme Radio Service is the same, whether or not it is incorporated.

If the business becomes insolvent and faces bankruptcy, however, the real benefit of incorporation to Copeland, Benson, and Anderson becomes apparent. In the unincorporated business the owner is liable to an unlimited extent, including his personal wealth, for the unpaid debts of the business. When the business is a corporation, the stockholder's liability is limited to the amount which he invested; wealth not invested in the corporation cannot be touched by creditors of the corporation.

Suppose the corporation owns properties which can be sold for only $5000, and it owes $8000. The creditors may not, as before, seize and sell Copeland's home and automobile. He owes them nothing. Only the Acme Radio Service, Incorporated, a legal person separate from Copeland and the other stockholders, owes anything. This corporation has unlimited liability for its debts, and the creditors may take in

payment anything owned by the corporation. If Copeland paid the corporation $1000 for his share in its capital, that sum became corporate property; that part of Copeland's wealth was risked in the business enterprise, and will be lost—but only that. As a stockholder, he has *limited liability;* he can lose only the amount he invested in the corporation's stock, because he is not personally liable for the debts of the corporation.

Many small businesses do not bother with incorporation. The legal costs, the necessity for reports and other formalities, and the possibility of special taxes on corporations may outweigh the advantages. In some enterprises of professional or confidential nature, such as legal and accounting firms, the privilege of incorporation may not be granted by the state. Furthermore, the advantage of limited liability often disappears because creditors may insist on a personal guarantee of payment from the individual owner or owners. Although there are many small businesses organized as corporations, it is the larger enterprise which finds the corporate organization practically a necessity.

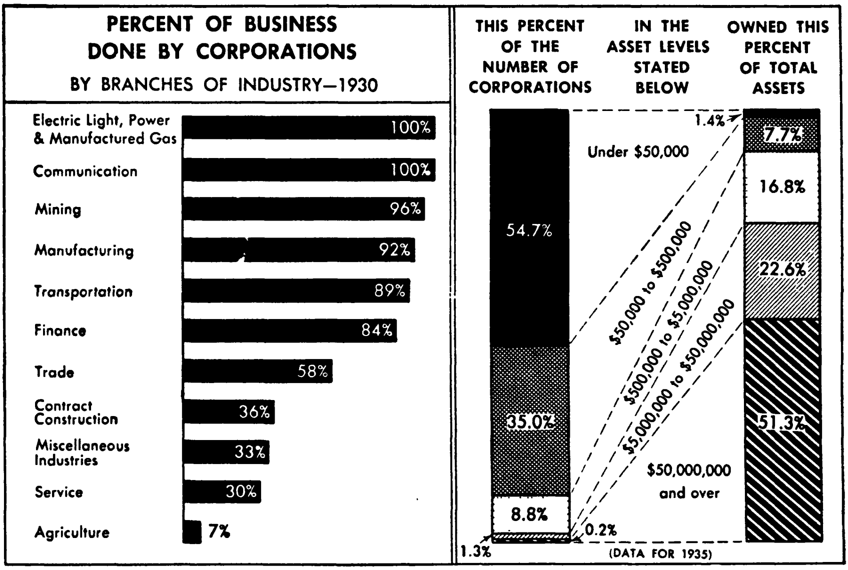
### Advantages of Incorporation in the Large Business

In 1945 the Standard Oil Company of New Jersey had over two and one-half billion dollars' worth of properties, or *assets* (see p. 203); U.S. Steel and General Motors each had almost two billions' worth. Many other enterprises were gigantic in financial value and size of operation. Modern industry requires large amounts of capital, more than can be provided by one individual or by a few partners. The corporation makes it possible to gather together into huge amounts the investments of many people. The small investor is willing to make an investment in a large enterprise because he can lose only the small amount he has invested. The large investor can invest in many enterprises at the same time because he knows that whatever may happen to one of his investments will not affect his other investments. Limited liability encourages people to make investments which otherwise they would not dare make. It therefore makes possible the giant businesses which have become a feature of our modern economic system.

Investment is further encouraged by another legal feature of the corporation, *transferability of shares.* The law allows a stockholder to transfer his shares at any time, and in any way, that he wishes. He may sell his shares, give them away, leave them as an inheritance for someone, or dispose of them in other ways. This is quite unlike the situation in a partnership. A partner may not transfer his share in the business to a new partner without the consent of the other partners. The fact that a stockholder can sell his shares at will makes him more likely to buy shares in a corporation than he would be otherwise. The buying and

selling of shares of large corporations is so relatively easy that people with savings are willing to take the risk of investment in these corporations.

The ease with which corporate shares can be transferred makes it possible for a person to use stock as a means of borrowing money. Banks and other lenders are willing to make loans to people who can put up shares of financially sound corporations as *security* for the loan. If the loan is not paid when due, the lender can usually sell the shares without




The chart on the left shows that in some industries the corporation is much more important than in others. The chart on the right shows that a few large corporations owned a disproportionate share of business assets and that the bulk of all corporations are relatively small in size. Thus 54.7% of corporations owned 1.4% of all assets, and less than 1% (0.2%) owned over half (51.3%). (Data from *Economic Prologue*, TNEC Hearings)

difficulty, and recover the money due him. The fact that corporate shares can be used to borrow funds when needed is another inducement to people to invest in the shares of corporations.

Legally, too, a corporation has *perpetual life;* it can last forever. This, again, differs from the partnership, which legally ends with the death of any one of the partners. Since a corporation is a separate person, it can continue to exist no matter what happens to its owners individually. In the large corporation this is important because it means that the business continues to function, regardless of changes in ownership. The individual owners may sell their shares, they may die one by

one; the corporation goes on just the same. Unless the corporation dies through bankruptcy or through being dissolved by its owners, it can live indefinitely. Many corporations have continued to operate for decades after their original owners have left the scene. The importance of the durability of corporations is apparent when we think of what would happen to the economic life of this nation if our great corporations had to be reorganized every time one of the thousands of stockholders died.

EXTENT AND IMPORTANCE OF INCORPORATION

These advantages—limited liability, transferability of share, and perpetual life—explain why the corporate form of business organization has become so important in the business world. During the quarter of a century from 1910 to 1935, while the total number of businesses increased by about 25 percent, the number of incorporated businesses increased by about 100 percent. As the scale of business operations grows, more businesses use the corporate form of organization to help raise the large amounts of capital needed. The chart on page 169 shows the importance of corporations in economic life.

The figures in the chart show that in industries like power, light, transportation, mining, manufacturing, and transportation, requiring large capital investment, the percentage of business done by corporations is very large; in agriculture, the service industries, and others in which a smaller scale of operations is possible, the percentage tends to be smaller. In 1945 there were over three million business firms, excluding farming, in the United States; only about 420,000 of these, about 13 percent, were corporations. In addition, almost all of the approximately six million farms were unincorporated. It is in scale of operation, rather than in number, that corporations play such a vital role in our economic system.

It would be a mistake to conclude that all corporations are large. The right side of the chart on page 169 shows that more than half of all corporations in 1935 had assets worth less than $50,000. These small corporations are, in effect, single proprietorships or partnerships, but they are legally organized as corporations.

The graph reveals another significant fact about corporate enterprise, which will be discussed in detail in a later lesson. The corporations with assets worth less than $50,000, though 55 percent of all corporations, owned less than 2 percent of all business assets; while the corporations with assets of over 50 million dollars, less than two-tenths of 1 percent of the total number of corporations, owned over 50 percent of all business assets. This is one evidence of the key role played by giant enterprises in our economic system, a role that is made possible by the legal device of incorporation.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| bankruptcy | creditor | single proprietorship |
| capital | incorporation | stockholder |
| certificate of stock | insolvent | transferability of shares |
| charter | limited liability | unlimited liability |
| corporation | partnership | |

### II Questions and Problems

1) Explain the procedures by which an insolvent concern becomes "discharged in bankruptcy."
2) Debtors, at one time, were imprisoned. Why are our bankruptcy laws a more sensible way of handling insolvency?
3) (a) Explain the difference in liability of the unincorporated and the incorporated business. (b) "The corporation has unlimited liability; the stockholders have limited liability." Explain, showing how incorporation makes this possible.
4) Copy and fill in the table below, comparing three forms of business organization:

| *Type of Organization* | *Liability* | *Transferability of shares* | *Duration* | *Method of Creation* |
|---|---|---|---|---|
| Single Proprietorship | | | | |
| Partnership | | | | |
| Corporation | | | | |

5) "Limited liability is a device for protecting businessmen against the consequences of their own errors." "Limited liability is a device which has made it possible for the capitalistic system to advance human welfare." Explain to what extent each of these statements is correct.
6) Which form of business organization would you recommend for each of the following? In each case give a reason. (a) A 20-acre vegetable farm, (b) a barber shop, (c) a chain of barber shops, (d) a restaurant, (e) a law firm, (f) a clothing factory.
7) Discuss this statement from a General Motors advertisement: "A big corporation is the most effective instrument that has ever been devised for the creation and widespread distribution of wealth."
8) J. P. Morgan and Co., international bankers, were a partnership until a few years ago, and were then incorporated. What reasons encouraged keeping this firm as a partnership for eighty years? What may have been reasons for the decision to incorporate?
9) On April 19, 1947, an article in *The Saturday Evening Post,* referred to the "incorporation" of Bobby Feller, major-league pitcher. (a) Explain. (b) What advantages may there be in forming a corpora-

tion for the "business personality" of a person with special skills or talents?

III Things To Do

1) Interview a businessman. Ask him what form of business organization he uses. Get his reasons.
2) Read and report on the history of a large corporation. For advanced students the following are suggested: (a) *History of the Standard Oil Co.* by Ida M. Tarbell (2 vols., Macmillan). (b) *Concept of the Corporation* by Peter F. Drucker (John Day), a study of the General Motors Corporation. (c) *Main Street Merchant: The Story of the J. C. Penney Company* by Norman Beasley (McGraw-Hill). See also the reading references in Lesson 37.
3) In class, dramatize incorporating an imaginary business.

# *LESSON* 23 CORPORATION MANAGEMENT AND FINANCE

## Management of the Corporation

Since a corporation is an artificial person, it cannot function in the same way as a flesh-and-blood person can. Its actions are really the actions of individuals who have the legal right to act in the name of the corporation. There are three groups of individuals who share in the management of the corporation: the stockholders, the directors, and the officers.

Every year the stockholders meet, as required by the law, to elect the directors of the corporation. Unlike elections for government office, in which each voter casts one vote, corporate elections usually allow a stockholder one vote for each share he owns. (Some types of stockholders, however, do not have the right to vote.) A stockholder with ten shares has as much voting power as ten stockholders with one share each. This procedure is based on the principle that the person risking a greater investment has more right to determine the policies of the corporation.

As the elected representatives of the stockholders, the directors have the responsibility of deciding the major policies of the corporation. The board of directors hires the officers of the corporation; it decides when and how much additional capital is needed, and in what way it shall be raised; it may give the officers directions as to production, prices, and research; it decides how the profits are to be distributed.

A corporation director is not an employee of the corporation, nor does he generally give full time to the corporation. He attends the meet-

ings of the board of directors from time to time, and may receive a small fee for attending. A person is usually chosen as director because he owns stock in the corporation, is a prominent man whose name will give prestige to the business, or is in some business related to the activities of the corporation. Frequently a wealthy or prominent person is a director of several corporations, and also engages in his own business or profession.

The day-to-day business of the corporation is carried on by the officers of the corporation. The officers are full-time employees and receive salaries for their services. They hire the workers, purchase materials and equipment, supervise production and selling, and arrange the financial affairs of the business.

In the small corporation, the stockholders, directors, and officers are often the same persons. The annual stockholders' meeting is merely a legal formality, since the few owners are in close contact with each other, working in the business and making decisions from day to day. It is in the larger corporations that a distinction appears between the stockholders on the one hand, and the directors and officers on the other hand. When the number of stockholders runs into hundreds, or into thousands, few of them have any direct contact with the business operations of the corporation. A tiny proportion of stockholders attend the stockholders' meeting, vote for the board of directors, and take the trouble to read the financial reports. Many of the stockholders become merely inactive investors.

In the larger corporation the responsibilities of management have to be divided among the various officers, who in turn divide their duties among their assistants. The major officers are the president; from one to a dozen or more vice-presidents, depending on the size of the business; a secretary; and a treasurer. The president may also serve as chairman of the board of directors, often the most important official of the corporation.

The diagram on page 174 shows the relationship of corporate activities to its structure and organization. It will be observed that all authority stems from the stockholders, through the board of directors and the officers, to all types of employees and activities. In larger organizations the work of the production manager and the financial and selling activities may be subdivided among several vice-presidents.

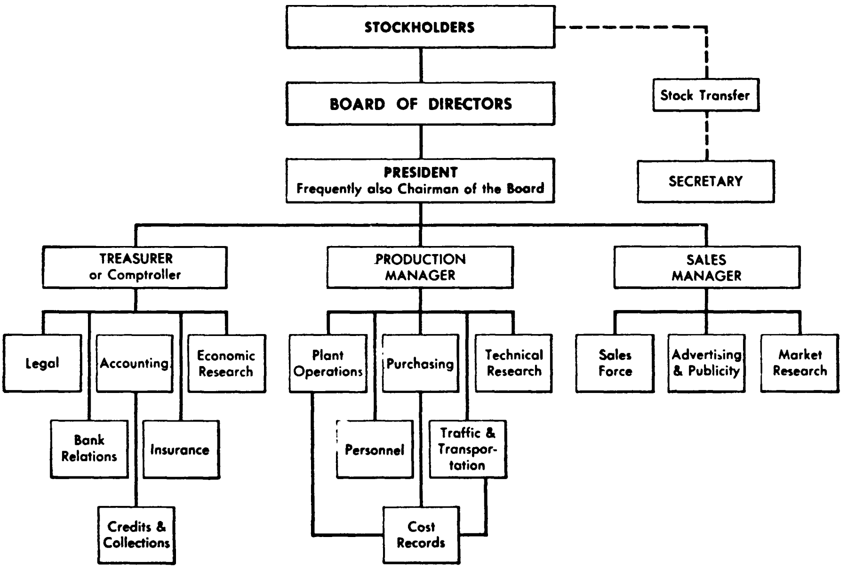
### Financial Rights of the Stockholders

Besides participating in the management of the corporation, the stockholders also share in the profits and in the proceeds of *liquidation.*

All profits belong legally to the stockholders. But the board of directors has the legal right to decide what part of the profits earned by the

business shall be paid out as dividends to the stockholders, and what part shall be reinvested in the business as *undivided profits.* Suppose that a corporation, with 5000 shares outstanding, has earned $50,000 in profits. The directors can then distribute the entire sum as dividends, giving each share a dividend of $10. The directors may decide, however, that the business needs $10,000 more in capital. They may there-

**CORPORATE ORGANIZATION AND BUSINESS FUNCTIONS**




This is an example of an organization chart. Each box represents an official or a department. The connecting lines show the direction of control or authority. All those below the board of directors are hired employees. The lower boxes give a picture of the functions performed in an enterprise, whether incorporated or unincorporated.

fore pay out only $40,000 in dividends, $8 per share, and leave the remaining $10,000 as additional capital in the business. The effect is to increase each stockholder's investment by $2 for each of his shares. In large corporations, in which the average stockholder is inactive, this reinvestment of profits is imposed by the board of directors upon the stockholders, who may sometimes feel dissatisfied with the size of the dividends. This practice of reinvesting, or "ploughing back," profits has made it less necessary for large corporations to depend upon new issues of stock as a means of raising capital.

"Liquidation" is the process of going out of business: selling all the assets, paying all the debts of the business, and distributing the proceeds to the owners. Liquidation may be voluntary, as when the owners

decide to retire from business, or it may result involuntarily from a bankruptcy proceeding. The stockholders are entitled only to what is left after all claims against the corporation have been paid.

### Types of Corporate Stock

A corporation may have different kinds of stockholders, whose rights to share in the management, profits, and proceeds of liquidation are different. All corporations issue *common stock,* which is the stock normally carrying the right to share in the management of the corporation. The rights of the common stockholders have been described above. Some corporations also issue *preferred stock,* which is stock entitled to a specified dividend, ahead of the common stock, and to a prior claim to the assets of the corporation in case of liquidation. Preferred stockholders usually have no voice in the election of the board of directors, although there are examples of preferred stock having voting rights. It is usual for preferred stock to be *par-value stock,* that is, stock having a stated, or face, value. The dividend is stated as a specified percent of the par value. Common stock is generally *no-par* stock; it has no face value. The dividend is stated as so much per share.

Suppose, for example, the ABC Corporation has outstanding 20,000 shares of no-par-value common stock, and 10,000 shares of 5-percent preferred stock, par value $100. The directors declare dividends of $210,000. Each holder of preferred stock must receive $5 per share (5 percent of the par value, $100). The 10,000 preferred shares would account for a total of $50,000, leaving $160,000 for distribution among the holders of the 20,000 common shares, or $8 per share.

Ownership of preferred stock does not guarantee receiving a dividend. There may be no profits, or the directors may not think it wise to declare dividends. The only assurance is that the holders of common stock will receive no dividends until the dividend on the preferred has been fully paid. Most preferred stock is of the type called *cumulative,* which means that no dividend may be paid on common stock until all dividends owing to preferred stockholders from previous years have been made up. In the example given, if no preferred dividend has been paid for three years, each holder of preferred stock would have to receive $15 a share before the holder of common stock could receive anything; this would leave only $60,000 for the 20,000 common shares, or $3 per share.

The preferred stock of a corporation normally is a more secure investment than its common stock. The preferred shareholders give up their chance to receive large dividends in exchange for getting their dividends before the common stockholders do. If profits are small, the common shareholder runs the risk of receiving no return at all on his

investments. When profits are large, however, the common stockholders may get much larger dividends than the preferred; there is no limit to the amount of dividend which can be paid to common stockholders.

Preferred stock is more secure than common stock in the event of the liquidation of the corporation. The preferred shareholder is paid up to par value of the share before the common stockholder receives any part of the liquidation proceeds. Suppose the ABC Corporation described above were to become insolvent, and liquidation were to yield only one million dollars in proceeds. The holders of the 10,000 preferred shares would be entitled to $100 a share, a total of one million dollars, and the common stockholders would lose their entire investment.

The fact that the preferred stock of a corporation is more secure than that corporation's common stock does not mean that every preferred share is a safer investment than every common share. A common share in one corporation may be a far safer investment than a preferred share in another. The measure of safety in the final analysis is the value of the corporation's properties and its profit-making ability.

### Borrowed Capital and Corporate Bonds

Business firms may secure capital by borrowing funds as well as by selling stock. The borrowing firm is generally required to give written evidence of the debt to the lender or creditor, specifying the terms of the loan. Such a document is called a *credit instrument.* The amount of the loan, the *principal,* is specified on the credit instrument and becomes its *face value.* A date for repayment is indicated; this is the *date of maturity.* The extra money to be paid for the privilege of borrowing is called "interest"; it is usually stated as a *rate of interest,* a percent of the face value.

Borrowing may be for a short period or a long period. A credit instrument stating a promise to pay a specified sum is called a *promissory note.* A special type of promissory note, used in long-term debts, is called a *bond.* It is common for large corporations to raise capital to expand plant and equipment by borrowing for a long period and issuing bonds to the lenders as evidence of the debt. Stocks and bonds are called *corporation securities.*

When the sum borrowed is small enough for a single person to lend it, the borrower issues a single bond. If the loan is secured by some property belonging to the borrower, a mortgage will be given. This document states that if interest or principal is not paid when due, the lender has the right to seize the property, and to recover what is due him from the proceeds of the sale of the property. When the amount borrowed is very large, running perhaps into the millions, bonds may be sold to many lenders. A mortgage covering all the bonds is prepared,

and a trustee, usually a financial institution, is selected to hold the mortgage and guard the interests of the individual bondholders. Corporate bonds secured by specific property are called *mortgage bonds.* Bonds not secured by a mortgage on property are called *debentures.*

A corporation may prepare gradually for paying back, or *redeeming,* its bonds at the maturity date (earlier if the loan agreement permits), by setting aside some money each year in a sinking fund. It may, just before the maturity date of an outstanding bond issue, borrow new money to repay the old debt when due. This is referred to as *refunding.*

Interest on bonds is a business expense. Since it must be paid at regular intervals, it is often referred to as a *fixed charge.* The bondholders are creditors; if the corporation does not pay interest or principal when due, the bondholders may petition to have the corporation declared bankrupt. Interest, therefore, differs from the dividend payments made by corporations. Dividends are not an expense; they are a share of the profits and are paid at the discretion of the directors. The stockholders, as owners, can express their dissatisfaction with financial results only by seeking to change the directors or policies of the corporation, or by selling their shares. This explains why the bonds of a corporation are normally a safer investment than its stocks.

### Problems of Corporate Finance

A corporation has three ways, then, of raising additional capital: reinvesting profits, issuing more stock, or issuing bonds. Each method has its advantages and disadvantages.

Issuing more stock is less risky than selling bonds, because no fixed charges are created and no debt has to be repaid. If the stock is bought by new stockholders, the risk is being spread over a larger number of investors. The disadvantage is that profits will have to be divided among a larger group. Control of the corporation will also be more scattered. These disadvantages will be reduced if preferred stock is sold instead of common stock. But then the common stockholders take the risk of having to wait for their dividends until the rights of the preferred stockholders have been fully met.

If the profits from the use of the additional capital are likely to be large, it may be wise to issue bonds instead of stock. The interest charges will be smaller than the dividends which would have to be paid on new stock, and more profit will be left for the existing stockholders. If expectations are not realized, however, the interest charges will be an added expense and will keep profits down.

The corporation may be able to avoid issuing new securities—stocks or bonds—by reinvesting some of the profits. This reduces the amount of dividends which can currently be paid to the stockholders. The stock-

holders may not mind this sacrifice if later profits and dividends should prove large; but there is no guarantee that this will happen.

These problems would be easy to resolve if it were possible to know in advance the results of the investment of the additional capital. There is no way to know this, however; it becomes a matter of judgment based upon experience. The management of the corporation bases its decision upon its analysis of business conditions. One consideration will be what they expect the future course of business to be. Another factor will be whether those who have funds to invest will be willing at that time to buy particular kinds of securities. This brings us to a study of how securities are sold.

### Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| bond | debenture | no-par-value stock |
| common stock | dividend | par value |
| corporate officer | face value | preferred stock |
| corporate director | fixed charge | principal |
| corporation securities | interest | promissory note |
| credit instrument | liquidation | rate of interest |
| cumulative preferred stock | mortgage | redemption |
| date of maturity | mortgage bond | refunding |
| | | undivided profits |

II Questions and Problems

1) (a) Compare the responsibilities of the directors and the officers of a corporation. (b) It is not uncommon for one person to be director in several corporations. It is most uncommon for one person to be an officer in more than one. Why?
2) Copy and fill in the table below, comparing the rights of holders of different types of corporate securities:

| | *Common Stock* | *Cumulative Preferred* | *Bonds* |
|---|---|---|---|
| Relation of security holder to corporation (owner or creditor) | | | |
| Type of income | | | |
| Order of payment | | | |
| Limits in amount of payment | | | |
| Remedies in case of nonpayment | | | |
| Right to vote | | | |
| Order of repayment in case of insolvency | | | |
| Limit to amount of payment if insolvent | | | |

3) The XYZ Corporation has the following securities outstanding: 3000 shares of no-par value common stock; 1000 shares of preferred, par value $100, dividend rate 8%; 40 bonds, face value of $1000, interest rate of 4 percent. (a) How much is paid per bond? (b) There are profits of $26,000 after payment of all expenses, including interest on bonds. The Board of Directors declares all but $3000 as dividends. How much is paid to each share of preferred stock? To each share of common stock?
4) If the XYZ Corporation in the previous question were to become insolvent after failing to pay bond interest for two years, what would each shareholder and bondholder receive in liquidation proceeds if the assets were sold for $143,200?
5) Suppose you have $1000 to invest. (a) Which of the three main types of securities would you rather buy? Why? (b) Would your answer be different if you had $1,000,000 to invest? Explain.
6) State an advantage and a disadvantage of each of three methods of raising additional capital in a corporation.
7) Bankruptcy has resulted from the overissue of bonds. (a) Why? (b) Suppose stock had been issued in place of the bonds, would bankruptcy have been less likely? Explain.
8) Comment on this advice: "An eight-percent bond—look out; an eight-percent stock—look it over."

## III Things To Do

1) More corporations are incorporated in the little state of Delaware than in any other state of the Union. Find out what there is about the Delaware laws that so attract corporations. For sources of information try *Frankenstein, Inc.* by I. Maurice Wormser (McGraw-Hill), or some book on corporation finance.
2) Bring to class a certificate of stock or a bond. Point out the important parts of their contents.
3) Bring to class a corporation charter. (a) Show how it illustrates some of the points made in this lesson. (b) Is there anything else in the charter that is of interest?
4) Find news items in the financial pages of the newspaper reporting changes in corporate managements or earnings. Explain them to the class.

# *LESSON* 24 SELLING SECURITIES

## Marketing New Securities

The corporation seeking new capital through the sale of securities faces selling problems. The type of security issued will be based partly on the wants of prospective buyers. The new issue must be announced

and advertised, investors must be sought out and convinced, and the actual transfer of ownership must be made.

The small corporation ordinarily does not sell securities to the public. If the need for additional capital arises, more money is invested by the owners or by individuals whom they know and solicit. The small corporation thus sells its securities directly to the investors. Larger corporations may also follow, but to a more limited extent, the practice of selling securities directly to the investor. This method of selling securities is known as direct selling or *direct placement.*

The selling of corporate securities is made simpler and less expensive if a large investor, such as an insurance company, buys directly all, or a considerable portion, of a corporate issue. Direct placement also occurs when corporations offer securities to employees on the basis of part payments deducted from wages. This gives employees an opportunity to invest without large outlay, provides an automatic form of savings, and may serve to give them a more personal interest in the enterprise for which they work. Direct placement also occurs when a corporation issuing additional shares offers them first to the existing stockholders.

Most of the selling of corporate securities is done through financial middlemen, of whom there are many kinds. The business enterprise which specializes in the sale of newly issued securities is called an *investment bank.*

Investment-banking firms generally maintain offices in the financial centers of the world, the Wall Street section of New York City, for example. They know, and are known to, important investors like insurance companies, banks, trustees of estates, wealthy individuals, and other large dealers in securities. Their staff is expert in all matters pertaining to the issue and sale of securities, and advises the corporate directors at all stages of the financial operation. Many large corporations have members of these banking firms on their boards of directors.

The investment bank may simply sell the securities for the corporation and receive a fee or commission. It is more usual, however, for the bank to guarantee the sale of the entire issue. This is called *underwriting* the issue. Suppose the corporation intends to issue the stock at $100 a share; the underwriting firm may immediately give it $98 per share for the entire issue. The $2 difference, minus selling expenses, is the profit of the underwriter. The corporation gets the capital immediately, and the underwriter assumes the risks of not being able to sell all of the issue at the expected price. When an issue is so large that one investment banker cannot underwrite it alone, a temporary combination of several investment banking firms may be formed for the purpose, with each agreeing to take part of the issue. Such a combination is called a *syndicate.*

Investment bankers sell securities by advertising in the financial sections of newspapers, also by circularizing, and sending salesmen to, those known to be possible investors. Neither the corporation nor the underwriter guarantees anything to the investor. It is true, however, that reputations for skill in analyzing investments, and for honest dealings, have made the names of established banking houses mean a great

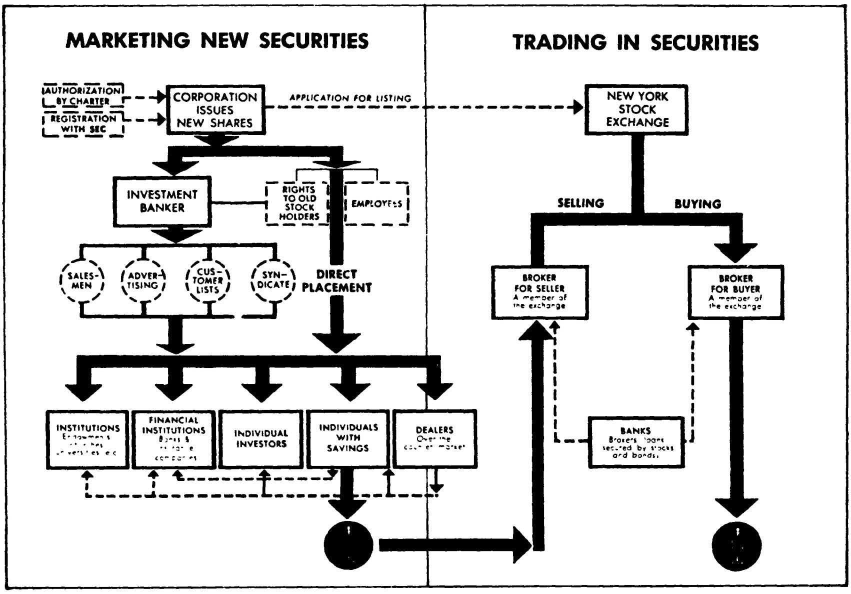



Chart by GRAPHICS INSTITUTE, N. Y.

The chart at the left shows the channels through which a new stock issue may move from the issuing corporation to an individual investor. It may involve an investment banker as middleman or, in some cases, may be by direct placement. The chart at the right shows how the securities exchange may be used if an investor wishes to sell his shares once they have been listed. Note that dealings on an exchange must be through broker members acting as middlemen.

deal to investors. Some protection is also given investors through the activities of Better Business Bureaus and by legislation. In the final analysis, however, it is up to the purchaser of securities to beware of the unknown enterprise with golden promises and glib salesmen.

The left side of the diagram on this page outlines the steps, described above, in selling new securities. The right side of the diagram shows in simplified form how securities are sold and bought after their original issue. Most of the trading in securities is of the second type, which is described below.

THE FUNCTION OF SECURITIES EXCHANGES

One of the main reasons that people are willing to buy the securities of established, financially sound corporations is the fact that it is easy to resell these securities quickly whenever their owners want to or need to do so. An *open and continuous market* for securities is an advantage to both corporation and investor. By this is meant a situation in which (1) details of all security sales are immediately available to all interested people, and (2) there is always a seller ready to sell at a stated price, and at the same time there is always a buyer ready to buy at a stated price. A *securities exchange* provides such a market.

A securities exchange is an association of individuals organized for the purpose of buying and selling securities. As members of the exchange, these individuals have the exclusive right to direct use of the facilities of the exchange. Other persons who may wish to trade in the securities handled on the exchange can do so only through the members, who collect a fee for this service. *Seats*, or memberships, on the exchange are limited to a specific number. After the exchange has been organized, a person can become a member only by buying a seat from one of the members. All members must meet the standards set by the exchange as to character and financial standing.

The largest securities exchange is the New York Stock Exchange, sometimes called the "big board." Another large one is the New York Curb Exchange, so called because it originated from trading done out-of-doors in the financial section. Boston, Cleveland, San Francisco, and other large American cities have exchanges, as do financial centers in other parts of the world, such as London, Paris, and Calcutta.

Some members of an exchange act as *brokers;* they buy or sell for individuals who are not members of the exchange, and receive commission as compensation. They do not themselves own the securities which they handle; they are merely agents for the buyers and sellers. Other members, who are called *dealers,* buy and sell securities in much the same way as merchants in other business fields. Either as brokers or as dealers, the members of an exchange have the advantage of being on the spot, able to react quickly to changing prices. Buyers and sellers need have no concern about exchange members' ability to fulfill obligations; their credit is certified by the exchange.

The value of an organized market such as a securities exchange is that it makes all the details of arranging a contract of sale completely standard, except for one thing, the price of the security. Only shares of corporations which have successfully applied for listing may be traded in. Only shares which are issued in large number are likely to be *listed,* so that it is almost impossible for one individual to buy all the shares, and thus *corner the market.* The exchange is open for trading only dur-

ing specified hours. All deliveries of stock sold, and all payments for stock bought, must be made by the third business day following the transaction; for example, Monday's transactions must be settled by the close of business on Thursday, unless legal holidays intervene. Bonds are traded in separately and are subject to special rules and regulations. These and other standardized rules make it possible for securities traders to focus attention exclusively on prices, which change frequently. Purchases and sales must be in round lots, usually in hundreds of shares. If an individual wishes to buy odd lots (not in units of one-hundred), the order would need the service of an *odd-lot broker* who combines small orders in lots of a hundred and charges an extra commission for the service. Prices are uniformly quoted in dollars and eighths of dollars. Thus, a share may sell for 15¼, which is $15.25 per share, and it would take $1,525.00 to buy 100 shares.

As transactions are completed, they are immediately recorded on the *ticker*, a telegraphic device which transmits messages from the floor of the exchange to offices of brokers and others throughout the country. For each transaction the ticker states the name of the corporation, the number of shares sold, and the price at which the sale was made. This is what makes the market an open one; all transactions are immediately known to all interested people.

Whenever a sale of securities is made, the name of the new owner is registered in the books of the financial institution which is acting as registrar for the corporation which issued the securities. Thus, there is assurance that the right persons will receive notices of stockholders' meetings and payments of dividend or interest.

### Speculation in the Securities Exchange

The term *investor* is often used to indicate a person who buys securities in order to get an income—dividends or interest—from the ownership of the securities. When he sells the securities, the reason is generally that he needs the cash or is dissatisfied with the income from this investment or has found a better investment. He is distinguished from the *speculator*, a person who buys securities for the purpose of making a profit from changes in the prices of the securities. Most of the trading on securities exchanges results from speculation rather than from investment.

Trading in securities has a terminology as colorful as that of sports. A *bull* is a speculator who buys stock with the expectation of selling it when the price has gone up. During the time he holds the stock, he is in a *long position* in the market. A *bear* is a speculator who *sells short* in anticipation of a price drop, and places himself in a *short position* in the market. This means that the bear sells shares at one price, expecting

to be able to buy them later at a lower price; the difference will be a profit. Since the rules of the exchange require delivery of the stock within three days, he borrows the stock through his broker, paying a fee for this service. Later he *covers* his short sale; that is, he buys the stock which he must return to the person from whom it was borrowed.

Every speculative transaction thus has two parts. The bull must eventually sell what he has bought, while the bear must eventually cover the short sale. In both cases, the profit depends upon the speculator's having judged correctly as to whether the price would go up or down. It is the business of the speculator to accept the losses which come from mistaken judgments, as well as the profits resulting from good judgments.

It is this speculative buying and selling which makes the exchange a continuous market. The more speculation, the easier it is for anyone to buy or sell a particular security at the time he wishes to do so. Speculation is carried on to make profits for speculators, but it has the effect of encouraging investment.

### Credit in Exchange Transactions

All transactions on a securities exchange are on a cash basis. Purchases must be paid for, and securities sold must be delivered, by the third business day following the transaction.

Nevertheless, it is possible for people to buy stocks on credit, through an arrangement known as *buying on margin*. The margin is the proportion of the purchase price which must be paid in cash. Mr. Jones, for example, orders his broker to buy 100 shares of stock at $40 a share. The broker agrees to accept $3000 in cash, giving Mr. Jones credit for the remaining $1000. Mr. Jones is buying on a 75-percent margin. The broker has to pay the full $4000 for the securities, however. He borrows the needed $1000 from a bank, leaving the 100 shares of stock as security for the loan. Ordinarily, the risk for the bank is small, because the bank can sell the stock to recover the loan. Danger would arise only if the price were to fall toward $10 a share, the part not covered by the margin. The higher the percentage of margin, the smaller the risk for the bank. In much the same way, selling short can also be done on margin.

Loans made by banks for stock-market transactions, with the securities held by the banks as protection against loss, are called *brokers' loans*. Such loans are made subject to repayment in twenty-four hours if the banks should so request, and are therefore also known as *call loans*. The smaller the amount of margin required from speculators, the more speculation can take place. On the other hand, if credit for speculation is tightened and margin requirements are increased, the scale of speculation will decline. Because of the important effects

which stock-market speculation can have on the business world, brokers' loans and margin requirements are regulated by the federal government, through the Board of Governors of the Federal Reserve System. (See Lesson 49.)

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| bear | direct placement | open and continuous market |
| broker | investment bank | seat on the exchange |
| brokers' loans | investor | securities exchange |
| bull | listing | short sale |
| call loans | long position | speculator |
| corner the market | margin | ticker |
| dealer | odd lot | |

### II Questions and Problems

1) Explain under what circumstances securities are sold (a) directly to the public, (b) through an investment banker.
2) (a) Why is the investment banker called "a middleman of finance"? (b) List the chief services rendered by investment bankers. (c) Explain how savings banks and insurance companies perform similar services.
3) In each of the following cases describe the method most likely to be used in raising the needed capital: (a) The A Corporation, a restaurant operator, needs \$2000 to redecorate. (b) The B Corporation, operating a chain of cafeterias, needs \$100,000 to open an additional unit. (c) The C Corporation, operating a nation-wide chain of restaurants, needs 30 million dollars to buy the ownership of a competing chain.
4) List and explain briefly the social services rendered by an organized securities exchange.
5) What is the advantage of having securities listed (a) to the corporations issuing them? (b) to the investors buying them?
6) (a) Explain, with examples, the difference between investment and speculation. (b) Explain what is meant by "buying on margin." (c) Explain what is meant by "selling short."
7) Mr. B bought 100 shares on the exchange when they sold for \$50 a share. He deposited \$3750 as margin with his broker. At the same time Mr. S sold short 100 shares at \$50 a share and deposited \$3750 with his broker. One month later, when the price per share was \$40, Mr. B and Mr. S. both instructed their brokers "to cover." (a) Who was the bull and who was the bear in this instance? Explain. (b) Who gained and who lost? How much? (Disregard commissions,

taxes, and other expenses.) (c) Whose broker would have been more likely to ask for more margin?

8) In 1928 and 1929, a seat on the New York Stock Exchange cost about a half million dollars, whereas since that time seats have sold for as low as $40,000. Why?

III THINGS TO DO

1) If possible, visit a securities exchange or a broker's office. Report to the class.
2) Read in *The Work of the Stock Exchange* by J. E. Meeker (Ronald Press, Revised, 1930), pp. 157–174 (a typical transaction), and pp. 175–201 (margin buying and short selling).
3) Interview an adult who has invested or speculated in securities. Ask him to summarize some of his experiences. Report to the class.

# *LESSON* 25 INVESTMENT AND SPECULATION

THE MARKET VALUE OF SECURITIES

The *market value* of a security is the price it brings in an actual sale. Where there is no market or no sale, one can only guess what price the security might bring. Thus, the shares of small corporations, held by a few owners, will have an estimated value, but probably not a market value.

For listed securities, traded upon an organized exchange, it is easy to secure an exact market value because the prices at which sales have been made are recorded and published. Prices of transactions are transmitted immediately by ticker and cable to brokerage and financial houses all over the world. Each day's prices are summarized in the financial pages of the newspapers that night and the next morning, and short summaries and quotations on selected shares are broadcast over the radio.

Sales of securities also take place outside the organized exchanges. In financial centers direct trading among dealers in both listed and unlisted securities is done mostly by bargaining over the telephone. Many of the prices bid by buyers and asked by sellers in such trading are regularly reported in the press under the heading of *over-the-counter market*. A good deal of private buying and selling of securities also takes place without any reporting of the prices involved.

The lists on page 189 were taken from the financial pages of the *New York Times* on Tuesday, August 9, 1949. They show the form used

in reporting securities quotations pertaining to trading on the previous day, Monday, August 8, 1949.

To find quotations for a share listed on the New York Stock Exchange, one would look for the abbreviated title of the corporation in the alphabetical list. (Elsewhere in the paper is a list of shares which were not traded in, together with the prices bid by buyers and those asked by sellers.) For example, we find in the list the shares of the American Telephone and Telegraph Company (Am Tel and Tel). We read in the first two columns that the *range* in 1949 was from 150⅝ to 138; that is, the highest price at which a share had been sold during the year, so far, was $150.62½ cents, and the lowest price was $138. The small "9" following the name of the corporation informs us that the share has paid $9 a year in dividends. (In some cases a small letter or symbol refers to notes at the end of the quotations, which provide further details about the dividend payments.) The first column to the right of the name informs the reader that 94 lots of 100 shares each were traded that day. Then there follow four columns of price quotations. The first price, or *opening price*, in the first column, tells us that the first sale that day was made at 143⅝. The next two columns give the range for the day's trading. The highest price was 144⅛, and the lowest was 143⅝. The column headed "Last" gives the *closing price*, or the price of the last sale before the exchange closed, 144⅛. The last column is headed "Net Change," which is the difference, plus or minus, between the closing price on this day and the closing price on the last previous day of trading. The "plus ⅝" in this case means that the closing price was 62½ cents higher than it had been on Friday, August 5th, the last previous day the exchange was open.

Bond quotations are listed separately. From the list shown it will be observed that except for the omission of an opening price, the facts given are much the same as for shares of stock. Large corporations often issue and list several types of shares; this is true of bonds as well. The American Telephone and Telegraph Company has eight different bond issues listed. The first of these, for example, carries 3⅛ percent interest, and the date of maturity is 1959. During 1949, the price of these bonds has ranged from 112¼ or $1122.50, per bond of $1000 face value, to 106⅜, or $1063.75. On this day 619 bonds were sold at prices ranging from a high of 112¼ ($1122.50 per $1000 bond), to a low of 111½ ($1115.00 per $1000 bond); the closing price was 112¼, or "plus ⅞" compared to the closing price of the previous day.

Quotations on the over-the-counter market are given by stating the prices currently being bid by buyers and being asked by sellers. Consulting the clipping given, we note that shares of the American Optical Company, paying $2 per share in dividends, were bid for at $33, and

that sellers were at that time asking $35. The market value of the share, on the basis of such data, could only be estimated to be between $33 and $35 per share.

### Factors in Market Value

The market value of a security is determined by supply and demand. If more shares are offered at a given price than are wanted at that price, the price will decline. If more shares are wanted at a given price than are offered at that price, the price will rise. The factors influencing the decisions to buy or sell a particular security at a particular price are many, varied, and complex. Any event affecting the safety of the investment, or the dividend or interest payments on the investment, influences people to buy or sell securities. These may be events applying only to the particular enterprise, or they may be events applying to enterprises and securities in general. Continuing losses by a particular business may make that company's investors willing to sell their shares at lower prices. A depression may cause a general desire to sell securities, and hesitation about buying, so that all security values will be lowered.

Buying and selling of securities are based largely upon expectations for the future. Although a corporation's previous record of profits and dividend payments will be carefully studied by careful investors, their decisions about buying and selling the corporation's securities will be based mainly on their judgments as to future developments. Moreover, over a period of time, the values of securities tend to move upward or downward together. Optimism or pessimism on the part of the businessmen, investors, and speculators as to what the future will bring may be expressed in a general willingness to buy or sell. Securities values also move together because of business interrelationships. If, for example, automobile corporations find business slow and lay off thousands of workers, the action may stimulate the selling of shares in steel corporations, since the automobile industry uses a large proportion of the steel produced. The anticipated decline in retail business, because of the workers' loss of buying power, may create pessimistic opinions regarding the future of other businesses depending upon consumer purchases. The effect may be a general decline in the prices of securities.

Readiness to buy or sell depends also on the purpose of the buying or selling. An investor may be satisfied if the security he buys, backed by sound properties, and with a long history of regular dividend or interest payments, continues to pay an income in the future, regardless of changes in the market value of the security. He will not ignore changes in market price, but his primary concern will be to get a steady income. The speculator, on the other hand, may be willing to trade in

## STOCKS—New York Stock Exchange

| Range 1949. High. | Low. | Stock and Div'd In Dollars. | Sls. 100s. | First. | High. | Low. | Last. | Net Chge. |
|---|---|---|---|---|---|---|---|---|
| 27½ | 21¼ | Am Stores 1.40a.... | 1 | 26½ | 26½ | 26½ | 26½ | − ⅛ |
| 37¼ | 31¾ | Am Sug Ref 4g..... | 2 | 36⅝ | 36⅝ | 36⅜ | 36⅜ | − ⅛ |
| 126½ | 120 | Am Sug pf 7....... | 1 | 123⅝ | 123⅝ | 123⅝ | 123⅝ | + ⅝ |
| 18⅜ | 16 | Am Sumat Tob 2... | 0 | 18 | 18 | 18 | 18 | .. |
| 150⅝ | 138 | Am Tel & Tel 9..... | 94 | 143⅝ | 144⅛ | 143⅝ | 144⅛ | + ⅝ |
| 71½ | 60¼ | Am Tobacco 3a xa.. | 9 | 70¾ | 71½ | 70¾ | 71 | + ½ |
| 63 | 49⅞ | Am Viscose 2¼g.... | 13 | 59 | 59½ | 59 | 59 | + ⅜ |
| 120 | 117¼ | Am Viscose pf 5.†... | 1 | 120 | 120 | 120 | 120 | + ⅜ |
| 8⅛ | 6¾ | Am Wat Wks .30g.. | 1 | 7⅝ | 7⅝ | 7⅝ | 7⅝ | .. |
| 38⅝ | 21⅝ | Am Woolen 4...... | 49 | 26¼ | 27 | 26¼ | 26⅞ | + ½ |
| 80 | 59¾ | Am Wool pr pf 4.... | 1 | 65 | 65 | 65 | 65 | .. |
| 6⅝ | 4½ | Am Zinc L&S .20g... | 21 | 6½ | 6⅝ | 6½ | 6⅝ | + ⅛ |
| 62 | 48½ | Am Zinc pr pf 5.†... | 20 | 61 | 61 | 61 | 61 | + 1½ |
| 35¼ | 25⅛ | Anaconda C 1½g.... | 38 | 29⅛ | 29½ | 29⅛ | 29⅜ | + ¼ |
| 35⅞ | 22½ | Anacon W & C 1g†.. | 390 | 27 | 28 | 27 | 28 | + 1½ |
| 35½ | 25½ | Anchor Hock Gl 2... | 7 | 35 | 35 | 35 | 35 | .. |
| 105 | 99½ | Anch H Gl pf 4....† | 10 | 105 | 105 | 105 | 105 | + ⅜ |
| 55¼ | 48¼ | Anderson Clayt 3... | 2 | 51½ | 51½ | 51½ | 51½ | + ½ |
| 23¾ | 15⅜ | And-Prich Oil 1a.... | 47 | 20¾ | 21½ | 20¾ | 21¼ | + ¾ |

## BONDS—New York Stock Exchange

| Range 1949. High. | Low. | | Sales in $1,000. | High. | Low. | Last. | Net Chge. |
|---|---|---|---|---|---|---|---|
| 92 | 76 | Am & FOR P 5s 2030...... | 4 | 86 | 85¾ | 86 | + ¼ |
| 112¼ | 106⅜ | Am T & T 3⅛s 59......... | 619 | 112¼ | 111½ | 112¼ | + ⅞ |
| 101¼ | 94 | Am T & T 2⅞s 87......... | 27 | 101¼ | 100⅝ | 101¼ | + ½ |
| 110⅜ | 103 | Am T & T 2¾s 57......... | 48 | 106½ | 106 | 106½ | + ⅜ |
| 104½ | 101⅛ | Am T & T 2¾s 661........ | 82 | 104½ | 104⅛ | 104½ | + ¼ |
| 99⅝ | 94½ | Am T & T 2¾s 75......... | 8 | 99⅝ | 99⅝ | 99⅝ | .. |
| 99⅞ | 92 | Am T & T 2¾s 80......... | 17 | 99⅞ | 99¾ | 99¾ | + ⅜ |
| 99 | 92 | Am T & T 2¾s 82......... | 3 | 99 | 99 | 99 | + ⅞ |
| 96⅝ | 88¼ | Am T & T 2⅝s 86......... | 37 | 96⅝ | 96¼ | 96¼ | + ¼ |
| 104⅞ | 103 | Am Tobacco 3s 62......... | 9 | 104¾ | 104⅝ | 104¾ | + ¾ |
| 81¾ | 79½ | Ann Arbor 4s 95............ | 2 | 79½ | 79½ | 79½ | .. |
| 128¼ | 122⅝ | A T & S F 4s 95........... | 8 | 128¼ | 128 | 128 | .. |

## OVER-THE-COUNTER QUOTATIONS

| | | |
|---|---|---|
| ABC Vending (80c)...... | 8⅝ | 9⅝ |
| Abitibi Pow&Pap (b25c).. | 10¼ | 11¼ |
| Aetna Stand Eng (b50c).. | 9⅛ | 9⅞ |
| Am Hardware (1)........ | 19¼ | 21¼ |
| Am Maize (1)........... | 15½ | 17½ |
| Am Marietta (1)......... | 10 | 11 |
| Am Optical (2).......... | 33 | 35 |
| Am Wringer (b75c)...... | 6½ | 8 |
| Arden Farms (b75c)...... | 9¼ | 10¼ |
| Argo Oil (b35c).......... | 8¼ | 9¼ |

*Securities quotations:* Enlarged reproductions of quotations for stocks and bonds in the New York Stock Exchange and the over-the-counter market as they appeared on the financial pages of the New York Times on Monday, August 8, 1949.

the shares of a corporation with a poor record of profits and dividends, if he has reason to believe the shares will change in market value within a relatively short period. If he anticipates a rise in value, he can buy the shares; if he anticipates a drop in value, he can sell them short. That is not to say that the speculator eagerly searches for unsafe investments; he prefers a safe investment, and he will consider earnings. However, the prospect of a change in market value in a relatively short period is his main concern.

Having advance, or "inside," information of an event that will cause a change in the market value of a security is of great use to the speculator. Suppose, for example, he learns that a particular corporation is going to receive profitable government contracts. Believing that the news will encourage investors to purchase this company's shares, he will immediately buy some shares. Upon the public announcement of the awarding of the contract, if he was correct in his expectation that it would cause a demand for the share and a rise in prices, he will be in the position to take his profit by selling the shares at higher prices than he paid for them. Similarly, if a speculator learns ahead of other people that a certain company's financial report is going to be unfavorable, he can profit by selling that company's shares short.

It has sometimes been possible for groups of speculators to create artificial conditions making for price increases or decreases; this is referred to as *rigging the market.* A group of secretly coöperating speculators, known as a *pool,* may take turns buying a particular share, so as to create an unusually large amount of buying. This tends to raise the price of the share, and encourages other people to buy these shares. After the price has risen, the pool quickly sells its holdings, and the price drops sharply. Those outside the pool, who purchased on the basis of price increases, may find themselves facing a considerable loss. A pool of speculators can also force the price of a security down by selling short. When other speculators, discouraged by the drop of price, decide to sell, the pool can buy the security at bargain prices. Rigging the market is contrary to the rules of the exchanges and is forbidden by law. Nevertheless, the practice is difficult to control completely, and uninformed speculators may suffer losses as a result of such manipulations.

### Comparing Investment Yields

One of the most important factors influencing investors in their buying and selling of securities is the *yield,* that is, the rate of return on the investment. The yield on any investment is calculated by dividing the income derived from the investment by the price paid for the investment. If a person has paid $50 a share for some stock, and receives an-

nual dividends of $3 per share, his yield is $3 divided by $50, or 6 percent. Another person may be getting an annual dividend of $4 on shares which cost him $100 each; his yield would be only 4 percent.

With reference to the securities of the American Telephone and Telegraph Company, as reported in the newspaper listing shown above, which was the better investment, the bond or the stock? The bond carries interest of 3⅛ percent; on a face value of $1000 it pays $31.25 per year. If bought on August 8, 1949, at the market price of $1122.50, its yield was as follows:

$$\frac{\text{Annual Income}}{\text{Market Value}} = \frac{\$31.25}{\$1122.50} = 2.8 \text{ percent, or the yield on the bond.}$$

The share of stock received a dividend of $9 on a market value of $144.12½ per share. The yield is computed in the same way as follows:

$$\frac{\text{Annual Income}}{\text{Market Value}} = \frac{\$9.00}{\$144.12\tfrac{1}{2}} = 6.2 \text{ percent, or the yield on the share.}$$

Income, as measured by yield, is only one consideration, however; the prospective investor would also consider safety and the prospects of future changes in market value and income. Many investors prefer bonds, with lower yields, to stocks, with higher yields. Generally, yields are lowest on securities which are least risky. Thus, in 1948, the average yield on United States Treasury Bonds was 2.44 percent; on corporate bonds, 3.08 percent; on preferred stocks, 4.13 percent; while on common stocks it was 5.6 percent. It must not be assumed, however, that the degree of risk can be judged merely by measuring the yield. To make a sound decision, the investor must know all the facts about the financial status of the company, and about the factors which may affect its future earnings.

### Protecting Investors

Investors are protected against sales of fraudulent securities and speculative rigging of prices, partly by the rules and regulations set by the exchange, and partly by federal and state laws. Many states have ***blue-sky laws,*** which prohibit fraud in the issue and trading of securities; the lack of uniformity, however, among the corporation laws of the forty-eight states has limited the value of this protection. A uniform incorporation law, to reduce the possibilities of abuse in security issue, has been recommended frequently.

Following the disastrous crash of market values starting in 1929, the Federal government in 1933 undertook the regulation of the issuance of new corporate securities. It created a commission, now known as the

Securities and Exchange Commission (SEC), which was given the power to require corporations issuing more than a given value in shares to file a *registration statement* with the Commission. This statement gives information about the proposed issue of securities, the purposes for which the new capital will be used, details of previously issued securities, financial statements of the corporation, and the salaries of the officers. The statement is available to the public at a small charge. The Commission does not, however, guarantee the desirability of the issue as an investment, or even certify that all statements in the registration statement are complete and accurate. Thus, despite the fact that an issue of securities has been registered with the SEC, the prospective investor must decide for himself whether the investment is a good one.

In 1934 the SEC was also given the job of supervising certain activities on the securities exchanges. As a result of the rules established by the SEC, all listed securities have to be registered; holdings of directors and officers must be reported to the Commission; the trading activities of directors and officers in the shares of the corporation with which they are associated are regulated and limited. Short sales on exchanges are subject to investigation by the Commission, and manipulation of prices is prohibited. There are also minimum margin requirements, but under the supervision of the Board of Governors of the Federal Reserve System.

Although the SEC and other protective agencies exercise some control over the capital-raising activities of corporations and over the practices followed in the day-to-day trading in securities, the investor still carries the burden of investigation and analysis of alternative investments that are proposed to him. To a great extent the rule still is, "Let the investor beware!"

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| blue-sky laws | over-the-counter market | rigging the market |
| market value | registration statement | yield |

### II Questions and Problems

1) (a) "Market value is the price at which a sale of the security is made on the exchange." Explain. (b) Why is market value different from par value?
2) Below is an excerpt from the New York Stock Exchange quotations as they appeared in *The New York Times,* March 18, 1950.

| Range 1950. High. | Low. | Stock and Div'd in Dollars. | Sls 100s. | First. | High. | Low. | Last. | Net Chge. |
|---|---|---|---|---|---|---|---|---|
| 18⅛ | 13¼ | DANA CP 1a...... | 37 | 18 | 18⅛ | 17¾ | 17⅞ | −⅛ |
| 24 | 21¾ | Davison Ch 1½.... | 3 | 23¼ | 23¼ | 23¼ | 23¼ | −⅜ |
| 34⅝ | 29⅞ | Dayt P & L 2...... | 14 | 34⅜ | 34⅝ | 34¼ | 34⅝ | +⅛ |
| 15⅜ | 11¼ | Dayton Rub .15e. . | 7 | 15 | 15 | 14¾ | 14¾ | −⅜ |
| 10 | 8¼ | Decca Rec ½...... | 29 | 9¼ | 9¼ | 8⅞ | 8⅞ | −⅜ |
| 25⅛ | 22 | Deep Rk Oil 2..... | 12 | 24¾ | 25⅛ | 24¾ | 25 | +½ |
| 47⅜ | 38½ | Deere & Co ¼e.... | 39 | 47 | 47⅜ | 46⅞ | 47¼ | +¾ |
| 36 | 29⅝ | Del & Hud 4...... | 4 | 34⅛ | 34⅛ | 34 | 34 | −¼ |
| 10⅜ | 8¾ | Del Lack & W¼e.. | 10 | 9¾ | 9¾ | 9⅜ | 9⅜ | −¼ |
| 31 | 26⅝ | Den & RGW 1e.... | 4 | 27¾ | 27¾ | 27⅜ | 27⅜ | −⅜ |
| 57½ | 46¾ | Den&RGW pf 5.... | 2 | 48¼ | 48¼ | 48¼ | 48¼ | +½ |
| 13⅜ | 12⅛ | Derby Oil ¼e..... | 6 | 12¾ | 12¾ | 12⅝ | 12⅝ | −⅛ |
| 23⅞ | 21¾ | Det Edis 1.20...... | 11 | 23⅝ | 23¾ | 23⅝ | 23⅝ | .. |

(a) Which share showed the greatest gain for the day? Which shares showed the greatest loss? (b) Which share had shown the greatest range thus far during 1950? (c) Which share had the highest closing price? What would 100 shares have cost on that day at this price? (d) What dividend had "Del & Hud" paid during 1949? (e) Assuming that you bought Deep Rk Oil at the closing price shown, and this corporation paid in 1950 the same dividend as in 1949, what would be your yield?

3) "Generally yields are lowest on securities which are least risky." (a) Explain. (b) Why is the speculator likely to pay less attention to yield than an investor does?
4) Explain the effect of each of the following events upon supply of, demand for, and price of, the corporation's stock: (a) An oil company "brings in" a new oil field. (b) A steel company receives large war contracts. (c) An air line files patents for an invention reducing chances of accidents. (d) An automobile company reports that depression is causing a drop in sales. (e) Congress rejects a bill for large-scale public housing, thus disappointing a manufacturer of heating equipment.
5) The New York Stock Exchange said in an advertisement, "Far too many people depend upon sources of financial information which are no more reliable than a fortune teller." Explain the significance of this statement to (a) investors, (b) the community.
6) (a) Explain two methods by which market prices for securities have been manipulated. (b) How are securities exchanges regulated?
7) "The SEC is the policeman of the financial world." (a) Explain this statement. (b) How have state governments done similar work in protecting investors?

## III Things To Do

1) (a) Assume you have $10,000 to invest in securities. On the basis of price quotations in the financial section of your daily newspaper, plan your investment. At the end of one month compute your gain or loss. (b) Keep a graph of daily price fluctuations of the securities.
2) Hold a debate on this subject: Resolved that speculation should be prohibited.
3) Look up the market prices of two stocks. Give as many possible reasons as you can for the difference in prices.

# LESSON 26 THE BUSINESSMAN AND HIS BANK

## SHORT-TERM CREDIT

Previous lessons have explained that business enterprises secure *long-term capital* from owners and creditors, through the sale of stocks and bonds. This long-term capital is used to buy land, buildings, machinery, and other properties which will last a long time.

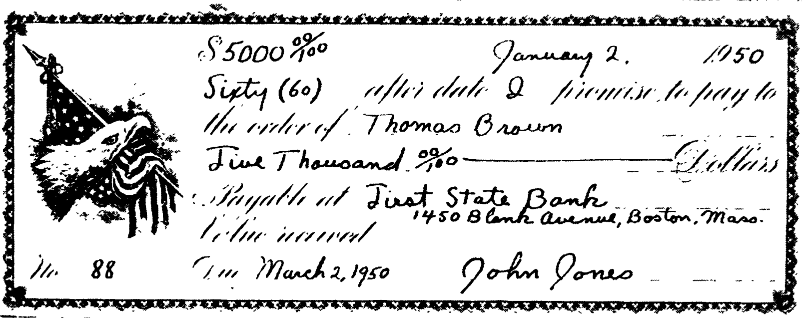
Business needs also a supply of capital to be used for purchasing raw materials, paying labor, and providing for the other current expenses of the business. This supply of capital is required for short periods at a time, and is called *short-term capital.* Let us suppose that it takes a manufacturing concern six months to turn raw materials into finished goods, to sell them, and to collect payments from customers. In a six-month period, the capital used to buy raw materials, to hire labor, and to pay for other costs of production will come back in proceeds from sales. It is therefore appropriate for the business to raise additional short-term capital by borrowing for short periods of time.

When a person receives goods, services, or money in return for a promise to pay at a future date, he is receiving *credit.* Such credit is based upon the confidence of the *creditor* (the one extending the credit) that the *debtor* (the person who owes the money) will have the ability and willingness to pay the debt on the due date.

In the American business world the most usual way for businessmen to get short-term credit or capital is through *open-book credit,* popularly called the charge account. The seller gives the buyer goods or services, and records upon his books the obligation of the buyer to pay for the goods or services within a stated time. Mr. Jones, for example, buys $5000 worth of goods from Mr. Brown on sixty days' credit. For sixty days Mr. Jones has the use of the $5000 worth of goods; during that time he can manufacture his products, sell the products, and get the money to pay the $5000 debt.

For greater security the seller may use a *credit instrument,* which is a document giving written evidence of a debt. The type of credit instrument used mainly in this country is the *promissory note,* which is a written promise to pay a given amount at a future date, as illustrated on page 195. One advantage to the creditor from having a promissory note is that if the debtor fails to pay on the due date, the note makes it easier to take legal steps to collect the debt. Another advantage is that the note, if properly worded, is *negotiable;* that is, the holder of the note can *endorse* it (sign his name on the back), and use it to pay a debt or to borrow from a bank.

Another type of credit instrument is the *draft,* which is a written order to the debtor to pay his debt to the creditor at a future date.[1] Mr. Brown, for example, might write a draft ordering Mr. Jones to pay the $5000 in sixty days. If Mr. Jones should indicate his willingness to obey this order by signing the draft, it would then be called a *trade acceptance.* The draft then gives the creditor the advantages of the promissory note. Drafts are used in certain industries in this country, and in foreign trade.


$5000 00/100 January 2, 1950
Sixty (60) after date I promise to pay to
the order of Thomas Brown
Five Thousand 00/100 Dollars
Payable at First State Bank 1450 Bank Avenue, Boston, Mass.
Value received
No. 88 Due March 2, 1950 John Jones

*Promissory Note.* John Jones, the debtor, is called the *maker;* Thomas Brown, the creditor, is called the *payee.* This 60-day note is without interest.

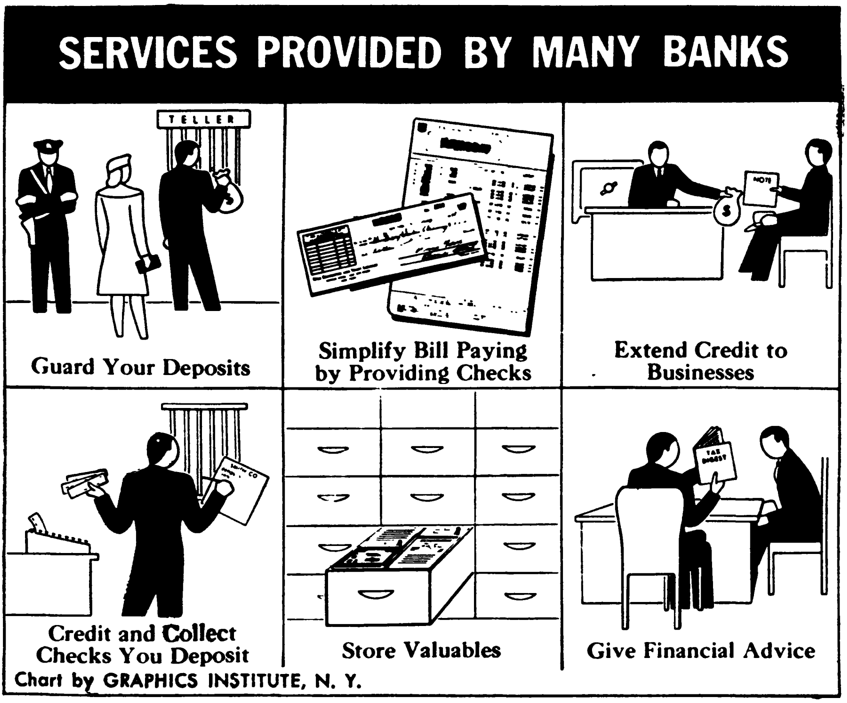
Another very important way in which businessmen get short-term capital is by borrowing from banks. A bank which specializes in providing short-term loans to business enterprises is called a *commercial bank.* Except for savings banks, most banks are commercial banks, regardless of whether they are labeled as "national bank," "state bank," or "trust company." As shown in the diagram on page 196, commercial banks furnish other services to businessmen, besides making loans.

The commercial bank accepts business deposits. This serves business in two ways: it provides a means of keeping surplus cash safely, and it makes possible the use of checks.

When a businessman deposits money in a commercial bank, he becomes the possessor of a checking account and is privileged to draw checks. A *check* is a written order by a depositor to his bank, ordering the payment of a sum to a specified person. Unlike a savings account, the deposit in a checking account receives no interest from the bank. In fact, the bank requires the depositor to keep at least a minimum *balance* in his account. If the number of checks drawn is large compared to the balance kept, the bank will charge for its services in the form of an *activity charge.*

[1] The draft may sometimes order payment to a third party, such as a bank.

Deposits in checking accounts differ from savings deposits in another respect; they must be paid by the bank on demand, that is, by presentation of a check. Hence they are called *demand deposits*. Savings-bank deposits, according to law, may require advance notice of intention to withdraw; this requirement is rarely exercised, but savings deposits are nevertheless called *time deposits*. Most commercial banks have a spe-




The chart depicts the services rendered by the typical commercial bank which specializes in serving businessmen. Compare these services with those rendered by the typical savings bank (see Lesson 15).

cial interest department in which they accept savings deposits. The businessman, if he wishes, may keep two accounts in the same bank, one to provide him with the convenience of a checking account, and one to provide him with interest on savings.

The commercial bank acts as agent for businessmen in collecting debts when there is written evidence of the debt in the form of a credit instrument. When a collection is made, the proceeds are added to the balance the businessman has on deposit, just as if he had collected it himself and made a cash deposit. The bank's charges for the collection service are deducted.

Commercial banks help the businessman when he has to make pay-

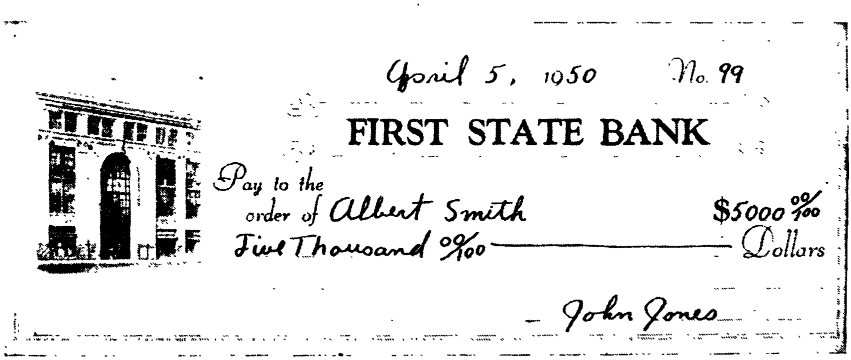
ments or receive payments in foreign money. They may help him to get reports on the credit standing of firms who wish to buy from him on credit. Their staff of experts is available to guide him in all matters pertaining to finance and investment, and the bank frequently acts as his agent in the purchase of securities for investment.

Another service provided by commercial banks is the renting of safe-deposit boxes for keeping securities and other valuables.

### Using Checks

The use of checks in making payments provides great convenience to business; more than 90 percent of all business payments are made by check, rather than cash, and many consumer purchases as well are paid for by check. Checks eliminate the need for transfers of cash, which are expensive and involve danger of loss. Checks also reduce the need for keeping large supplies of cash on hand and provide an automatic receipt for payments made.

Suppose, for example, that John Jones must make a payment of $5000 to Albert Smith for raw materials purchased. If there were no checks, he would have to deliver that sum in cash. He would have to engage messengers, provide protection, and would worry constantly about possible loss. Smith would have similar concern about safeguarding the cash from the moment he received payment and signed a receipt. Instead, provided Jones has the necessary amount in the bank, he may draw a check payable to Smith as follows:




**Check.** The *drawer* of the check, who is making payment, is John Jones. The *drawee* is the bank. The *payee*, who is being paid, is Albert Smith.

Jones would not worry if the check were lost in the mail en route to Smith. It is made payable to Smith; it must be endorsed by Smith before it has any money value. Were a stranger to find it and forge Smith's endorsement, Smith would lose nothing; the bank or individual accepting it would bear full responsibility. Smith would therefore be unwise

to endorse the check before he is ready to turn it over to the bank, or to some individual; if a stranger found it already endorsed, he would not need to forge an endorsement, and the bank cashing it would have no responsibility. If the check never reached Smith, he would notify Jones that his bill was still unpaid. Jones, before issuing a new check, would order his bank to refuse payment on the lost check, should it ever turn up. This practice is called *stopping payment.*

Suppose that Mr. Jones, in error, issued the check for $5000 but had only $3000 on deposit. When his check is presented for payment, the bank will refuse it, indicating that there are "Insufficient Funds." Mr. Smith will now again look to Mr. Jones for payment. To avoid getting a check for which there may be insufficient funds, Mr. Smith could ask Mr. Jones to take his check to the bank and have the bank certify that it is setting aside $5000 to meet that check. Such a check is called a *certified check.*

Mr. Smith does not have to go to Mr. Jones' bank in order to cash the check. He goes to his own bank and deposits the check, as if it were already cash. His bank, through an arrangement known as a *clearing house,* arranges to collect that sum from Jones' bank. The amount of the check is added to Smith's deposit balance by his bank, and will be deducted from Jones' balance by his bank.

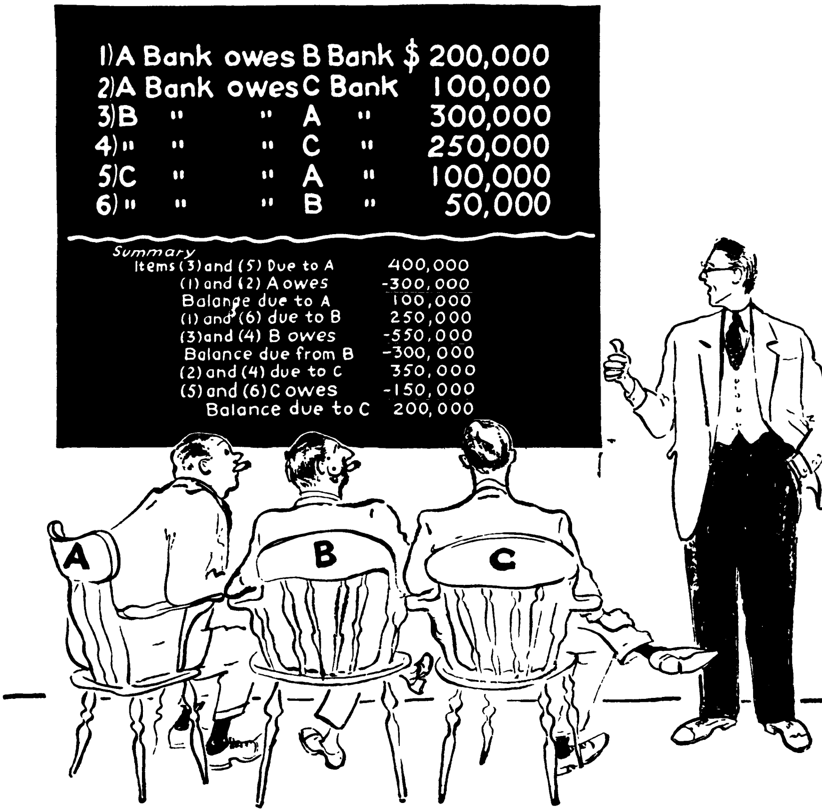
At the end of every month each depositor gets a statement from his bank telling what has been added to, and deducted from, the balance he had at the beginning of the month, and how great a balance remains at the end. Accompanying the statement is a package of the depositor's checks which were received and canceled by the bank during the month. A canceled check is a check which has been stamped by the bank to show that it has been paid. These checks provide legal evidence of the payment of debts. Provided the businessman makes a notation on the check as to the debt which is being settled, he has an automatic receipt. The endorsement on the back of the check is conclusive proof that the payment was received.

### The Clearance of Checks

Checks go through a process which is known as clearance. After Mr. Buyer draws a check on Bank A to pay Mr. Seller, the check is deposited in Bank B, Mr. Seller's bank. This happens many thousands of times each day in any large city. Now Bank B must get that check to Bank A, which has been ordered to pay it. Almost from the beginning of banking, it was obvious that there is waste and danger of loss involved in sending a messenger to deliver the check and get the cash. Since so many banks are involved, it would mean many messengers, many trips, and many losses. Why not have one messenger from each

bank meet at one central place, match checks, and settle all accounts at once? Such an organization for settling the obligations of banks to each other, arising from checks drawn and collected, is called a "clearing house."

A clearing house operates in a city or locality and is supported by banks which participate as members. How this saves time and duplication is shown in the diagram below.




A clearing house serves as a bookkeeping mechanism to reduce the need for transfers of cash. In this example two banks would have their clearing-house balances increased (A Bank by $100,000 and C Bank by $200,000), and one would have it decreased (B Bank by $300,000).

The amount of cash moving about the city, to and from banks, is reduced to a minimum. Each bank has an account with the clearing house, and transfers among these accounts are made usually by book entries, only occasionally by transfer of cash. Payments are made rapidly and efficiently.

The Federal Reserve System is used to clear accounts of banks in dif-

ferent cities. The clearance system enables businessmen to get, with a minimum of delay, the proceeds of the checks they deposit.

### Commercial Bank Loans

Supplying the additional short-term capital needs of businesses is the chief function of the commercial bank. Normally business enterprises buy raw materials and pay wages out of their invested capital. However, during the busy season, or when it is decided to expand operations, additional funds for these purposes may be necessary and will have to be borrowed.

Suppose that Mr. Jones needed approximately $5000 additional to purchase raw materials and pay labor. He would apply to the loan department of the bank in which he keeps his deposit account, and with which he regularly does business. The bank has the records of his balances in the past and therefore already has considerable information useful in appraising his ability to repay. They would, however, make further investigation, secure additional statements from him, and discuss with him the purposes to which the loan would be put and the possibility of the business' being able to restore the borrowed sum within the time of the loan.

It is often said that "Credit is based on the three C's—character, capacity, and collateral." The term "character" refers here to the reputation of the would-be borrower—his honesty, his promptness in paying debts, his general ability, and the confidence he inspires in the lender. One measure of his character is his previous credit history. For this reason, banks, businessmen, and other lenders insist on references. The story is told that J. P. Morgan once refused a loan of $100,000 to a friend, but offered "to do something just as good . . . I'll walk across the street with you." Obviously this would be a subtle way of giving a character reference.

"Capacity" means the ability to repay. If the funds are to be used for purposes which, in the given set of circumstances, have a good chance of being successful, the lenders have reasonable confidence that the borrowers will repay the loans.

The bank may wish to hold some sort of security or guarantee of repayment. For short-term loans it is very common to ask the borrower to let the bank hold marketable securities which can be sold in the event of non-payment; this type of security is called *collateral.* Another procedure is to ask for the guarantee of a responsible individual who will be asked to sign the promissory note along with the borrower. Such a guarantor is a co-signer, or co-maker. A third practice is to ask for a mortgage on some property, such as land, buildings, or machinery. When agreement has been reached on the terms of the loan, a loan

agreement is prepared and signed. The borrower then signs a promissory note.

In bank loans it is customary for the bank to deduct the charges in advance. Thus, in the example given, Jones would make out a note promising to pay the bank $5000 in 60 days. The bank would deduct a percent of this face value in advance; this advance deduction is called a *discount.* In fact, the entire borrowing procedure is often described as *discounting;* in this example we might say that "Mr. Jones discounts his own 60-day note." If the discount rate was six percent, the bank would add to Mr. Jones' deposit account a sum which was six percent less than the $5000 he borrowed. Six percent of $5000 for one year (a year is most often considered to have 360 days) is $300; for 60 days (figured as one-sixth of a year) it is $50. Mr. Jones would therefore have $4950 to use as a result of securing this loan. By drawing checks he would pay his expenses; and his balance would probably shrink, until income began to come in, enabled him to increase deposits, and caused his balance to rise.

At the end of the 60-day period, when the loan becomes due, Mr. Jones should have a sufficient balance in his deposit account to repay the loan. If he was correct in his expectation that the raw materials and labor purchased with the proceeds of the loan would be returned quickly in the form of income from the sale of finished goods, his balance would automatically grow. Checks would begin to come in from customers and would be deposited, adding to his balance. Some time before the due date, the bank would remind Mr. Jones of the need for building up his balance, by sending a formal notification. Upon the due date the bank would charge his account for the $5000 due; that amount would be deducted from Mr. Jones' balance. Thus a loan from a commercial bank to a businessman is not a matter of handing cash back and forth through the teller's window. It is a bookkeeping arrangement, through which the bank temporarily increases the borrower's checking account balance, without his making any deposit. Likewise, repayment of the loan merely means reducing the debtor's balance, without his making any payment of cash to the bank.

An active business may stand in constant need of loans of this sort. In order to avoid the need for repeated investigation and negotiation the bank may agree to extend credit automatically up to an agreed limit. This arrangement is called a *line of credit.* If Jones has a $5000 line of credit, the repayment of one loan automatically authorizes him to borrow an additional $5000. In fact it means that he may constantly stand in debt to the bank in the amount of $5000, provided he is willing and able to meet the continuing discount charges made by the bank for its credit.

### Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| activity charge | creditor | negotiable instrument |
| check | debtor | open-book credit |
| certified check | demand deposit | promissory note |
| collateral | discount | short-term capital |
| co-maker | draft | stop payment |
| commercial bank | endorsement | time deposit |
| credit | line of credit | trade acceptance |
| credit instrument | long term capital | |

II Questions and Problems

1) State six ways in which a businessman may use the services of a commercial bank.
2) Explain each of these statements: (a) "A bank lends deposits, not cash." (b) "The modern bank is a financial department store."
3) The A corporation and the B corporation both started in business at the same time with the same investment. A year later A borrows $10,000, while B goes along on its own capital. (a) Does this show that A has been less successful than B? Explain why or why not. (b) What is the value of a line of credit?
4) A check is a device for transferring bank balances. Explain.
5) Mr. A makes out a check payable to the order of B. C finds it, forges B's endorsement, and uses it to pay D for merchandise. (a) Should D's bank accept the check for deposit? Explain. (b) B asks A for another check to replace the lost one. Should A give it to him? Why?
6) A makes out a promissory note reading, "I promise to pay to B $500." Why is this note not negotiable? (What words are missing that appear on the note on page 195?)

III Things To Do

1) Bring to class samples of the credit instruments described in this lesson. Explain them.
2) Prepare a class dramatization of a typical commercial loan transaction.
3) Bring to class a canceled check, and explain what the cancellation means.

## LESSON 27 BUSINESS ASSETS AND BUSINESS FUNDS

### Tangible and Intangible Assets

A business enerprise must have some cash on hand so that it can pay bills and buy what it needs. But if a business were to keep all its capital

in the form of cash, it could make no profit. Some capital must be used to acquire factory, machines, and raw materials for manufacturing; or salesrooms, fixtures, and merchandise for selling. Business capital, to serve its purpose of earning a profit, must be invested in varied types of assets. An *asset* is anything owned by the business, related to its operations, and having a value.

Under the heading "Business Opportunities," the following advertisement recently appeared in a daily newspaper:

> FOUNTAIN, luncheonette—good lease, location. Price $12,000. 1234 Blank Avenue

A prospective purchaser of the business would be interested in the nature and value of the assets owned by the business. A luncheonette would have counter equipment, utensils and dishes, tables, chairs, foodstuffs, and so forth. These are articles that can be seen, touched, and handled; they are called *tangible assets.*

It will be noted that the advertisement mentions no tangible assets. It does, however, stress a good lease on a desirable location. In a business of this sort, or any retail business, the location and the lease which guarantees its possession for a long period, may be the most valuable assets of the business. In the sale of the business, the value of the location may bring more money than all the tangible assets put together. It is not unusual for the buyer of a retail business to pay a large sum for a store, and then to throw out all the old fixtures and replace them with new ones. A good location is an example of an *intangible asset,* that is, a privilege, or right, or other advantage which has value. Patents, copyrights, trademarks, brand names, or reputation with customers may be intangible assets. Often the general value of the firm's reputation and patronage is called *good will.*

The value of any asset is recorded by the business as the price paid for it. Accountants have established the same rule for intangible assets. Suppose, for example, the advertised luncheonette had only $8000 worth of tangible assets and no debts to anybody. If a purchaser were to pay $12,000 for the business, he would be paying for something extra, something intangible, possibly the opportunities for extra profits presented by a choice location. The buyer of the business would therefore be justified in recording $4000 worth of good will among the assets of the business. On the other hand, a business with an excellent reputation, and owning a brand name that has valuable preference in the minds of consumers, may show no good will among its assets, because it has not actually paid for it. A *patent* (see p. 286) may be known to be worth a great deal of money, yet it may be shown on the books at only a fraction of what it is worth.

## Fixed and Current Assets

A luncheonette proprietor refers to many of his tangible assets as "fixtures." This is an appropriate term for such assets as counter equipment, tables, dishes, and chairs, because he bought them to use for a long period of time. They are not like the foodstuffs, candy, and tobacco products, which he bought to resell. Assets used in a business for a long period of time are called *fixed assets.* Typical of fixed assets used in business are land, buildings, machinery, equipment, and furniture and fixtures.

Fixed assets do not remain exactly the same as they were when purchased; they wear out gradually. The loss of value which is the result of gradual wear-and-tear of a fixed asset is called *depreciation*. Suppose a fixed asset were bought for $1200, and the businessman estimated that it would last five years, after which it would sell for $200 in the second-hand market. The reduction in value during the five-year period is $1000; divided by five, it is $200 per year. This is the amount which must be deducted each year for depreciation. Sometimes fixed assets lose usefulness because they must be replaced by more up-to-date, more efficient equipment. When an asset loses its value for this reason, we speak of its becoming obsolete. It is possible, when such losses are an important factor, to estimate them and to make gradual deductions as in the case of depreciation.

Other business assets are in continuous circulation in and out of the business, within relatively short periods of time; these are called *current assets*. One of the most important of the current assets is known as *inventories,* that is, the goods owned by a business, in finished or unfinished form, which are intended to be sold. The foodstuffs in the luncheonette are purchased for preparation and sale. A retail store has merchandise on its shelves awaiting sale. A manufacturer has raw materials, which he aims to convert into finished goods and to sell. Another current asset is cash, which may be used at any time to purchase things. Still another current asset arises out of the fact that goods are sold on credit, and money will be due from customers in a relatively short period. The right to receive these payments when due is referred to by the term *receivables*. If the money due to the business is on open-book account (see page 194), it is an *account receivable.* If it is evidenced by a note or other short-term credit instrument, it is a *note receivable.*

The flow of current assets in a business is illustrated in the diagram which appears on the opposite page.

The diagram assumes that all purchasing is for cash; if goods are bought on credit, the amount of cash needed will be reduced. A manufacturing business buys raw materials; by doing so it changes the current asset, cash, into the current asset, raw-materials inventories. When,

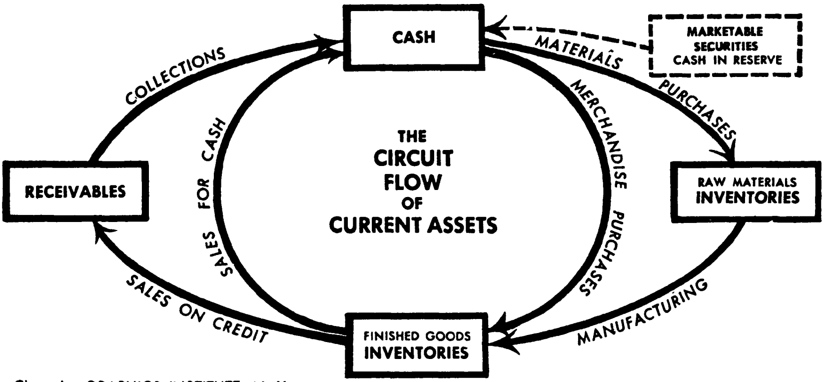



Chart by GRAPHICS INSTITUTE, N. Y.

**Start with "Cash" and follow the arrows around in a complete circuit. Each operation converts cash into another type of asset. Each complete circuit represents a turnover of capital. It should be noted that the volume of business will depend upon the use of credit, not shown in the diagram, as well as upon the use of cash.**

as a result of further outlays for labor and other production expenses, the raw materials are processed, the current asset, finished-goods inventories, has been substituted. Sale of the finished goods for cash will restore the original cash outlay and produce a profit. Should the sales be made on credit, the restoration of cash would be postponed until amounts outstanding are collected. In the meantime receivables are a current asset. The business engaged in buying and selling only finished articles follows the same pattern, except for the steps of raw-materials purchases and production. Service industries have current assets in the form of cash, receivables, and materials needed in rendering its services. If a business has more cash than it needs, it may put some cash into a savings account, or invest it in easily marketable listed securities. These savings or investments can be quickly turned into cash when the need arises.

This in-and-out circulation from cash to goods and receivables and back to cash again, is characteristic of the use of current assets. Because inventories, receivables, or other current assets are likely, in the normal course of business operations, to be turned into cash, they are called *liquid assets*. An asset is liquid if it can be readily turned into cash at full value. Cash, of course, is perfectly liquid; listed securities are also liquid assets. If inventories cannot be sold except at substantial losses, or if receivables cannot be collected within a short period, they may be considered as *frozen assets*. Frozen assets are those which are normally liquid, but which, for some reason, have become incapable of sale at full value. Frozen assets may be the first sign of insolvency; a business,

for example, which cannot sell inventories or collect receivables fast enough to meet its own obligations, is in danger of being forced into bankruptcy.

Some businesses have a higher proportion of fixed assets than others. Manufacturing and transportation, under modern conditions of machine production, require large plants, many expensive machines, and intricate equipment. Trackage, land, signaling systems, and rolling stock make up the bulk of the value of the railroad's assets. A retail establishment, although it may have many fixtures, an expensive building, and a fleet of delivery trucks, will have a larger proportion of its investment in inventories and receivables. The type of assets used in a business will strongly influence the amount of capital needed and the methods used in raising capital funds.

### Determining Capital Needs

The scale of operations of an enterprise will determine the amount of capital needed. A giant factory will need more than a small shop; a department-store owner will need much more than a street peddler. The amount of capital required will depend, too, upon the type of assets which the enterprise must use. A trucking business can be operated successfully on a small scale; but a railroad requires so much investment in fixed assets that it must be operated on a large scale, with a great deal of capital.

The capital which the business will have to invest in fixed assets must be held for long periods. It would not do to borrow money on a short-term basis to buy a factory which would require a number of years to pay for itself out of its earnings. Therefore, enterprises with a high proportion of fixed assets are likely to issue many shares of stock, or sell bonds, to get capital. Businesses whose assets are mainly current assets may rely mainly on short-term credit for their capital. Most businesses use both long-term and short-term capital. A retail establishment, for example, will need some long-term capital to pay for fixtures, trucks, and building, and for a minimum supply of merchandise. When the need arises for additional capital to finance expansion of inventories for the busy season, the retailer can resort to short-term loans for that purpose.

The amount of capital a business needs to finance its purchase of materials and supplies and to pay production expenses depends upon another factor, the rate of turnover. The *rate of capital turnover* is the number of times during the year the same capital is used. Suppose it requires $1000 to produce and sell goods which bring in $1200 when sold. If, in one case, it takes one week to produce the goods, to sell them, and to collect from customers, the same $1000 may be used to

finance the next week's production and sales, and $200 would be earned as profits during each week. If this continues for 52 weeks, total sales would amount to 52 times $1200 or $62,400 for the year, and profits would amount to 52 times $200 or $10,400 for the year. The $1000 was used 52 times in the year, and the rate of capital turnover was 52. Suppose that, in another case, it took twice as long to produce, sell, and collect; the $1000 could be used only half as many times, and the rate of capital turnover would be 26. The result would be that the $1000 of capital would produce sales of only $31,200 for the year (26 x $1200) and profits of only $5,200 (26 x $200). To equal the sales and profits of the first case, $2000 of capital would have to be used. The greater the rate of capital turnover, the lower the amount of capital needed to finance the production of a given volume of sales.

Retailers pay particular attention to the *rate of inventory turnover,* which is the number of times the inventory moves in and out during the year. If inventory turnover is high, sales can be large with a smaller amount of capital tied up in inventories. Thus a store which has an inventory turnover of 10 can achieve twice as much in sales, with a given amount of money invested in inventory at one time, as the store which has a turnover rate of 5. Some retailers operate on the principle of cutting prices to encourage a high rate of turnover. Each complete turnover of inventory brings only a small profit; however, the small profit multiplied by a high rate of turnover tends to make total profits high. A high turnover rate also has the advantage of reducing the risks of having merchandise spoil, go out of style, or drop in price while awaiting sale.

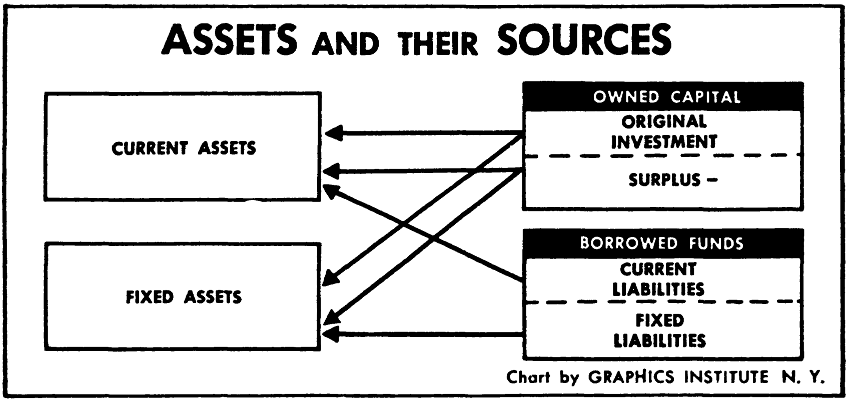
### Sources of Business Funds

Who puts up the funds to acquire the assets that a business owns? In general, the funds are the property of two groups, the owners of the business and the creditors. The owners put up funds when they make their original investment in the enterprise. In a corporation the *capital stock* represents the amount which the corporation received for its shares of stock; the total capital stock outstanding is the measure of the original investment. In addition, the owners have an interest in the *undivided,* or *reinvested,* profits. This is most frequently recorded by corporations under the title of *surplus.* Capital stock outstanding, plus surplus, measures the total of the owners' capital.

Assets may be acquired on credit, but this creates *liabilities,* which are the sums owed by the business. The total of the liabilities of a business measures the contributions of funds made by creditors. Liabilities which are due within a short period, a year or less, are classified as *current liabilities.* This includes accounts payable, which are open-book

debts to those who sold the firm goods on credit. Short-term debts involving notes or other short-term credit instruments, are recorded as *notes payable*. Long-term debts of a business, such as bonds, are its *fixed liabilities*, sometimes referred to as its *funded debt*. The total of current and fixed liabilities measures the amount of borrowed capital in use in the business.

The chart which follows shows the relationship of business assets to the sources of the funds by which they are acquired.




Funds used to acquire assets may be borrowed or may be invested by the owners. It is not, however, considered sound practice to borrow for long periods (fixed liabilities) to pay for current assets, or for short periods (current liabilities) to buy fixed assets.

The *net worth* of a business means the total value of the owners' interest in the assets of the business. In the diagram, where it is called *owned capital*, it is seen to be equal to the original investment of the owners, plus the surplus. It represents the net value of the business assets after the liabilities to creditors are deducted. Thus the net worth of a business may be computed by subtracting the total liabilities from the total value of the assets.

A frequently used measure of the success of a business is the comparison of profits with the net worth. For example a business with a net worth of $25,000 and annual profits of $5000 would have *a rate of return on net worth* of 20 percent. Another business with net worth of $100,000 and annual profits of $5000 would have a lower rate of return on net worth, only 5 percent. Since the primary aim of a business is profit, the rate of return on net worth may be regarded as a more significant measure of the success of a business than the value of its assets or of its net worth. For some purposes, however, as we shall see in the next lesson, businessmen will prefer to measure profits in relation to sales.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| accounts payable | fixed liability | notes receivable |
| accounts receivable | frozen asset | rate of capital turnover |
| asset | funded debt | rate of inventory turnover |
| capital | good will | rate of return on net worth |
| capital stock | intangible asset | receivables |
| current asset | inventory | surplus |
| current liability | liability | tangible asset |
| depreciation | liquid asset | |
| fixed asset | net worth | |

### II Questions and Problems

1) In each of the following enterprises, what would be one very important or necessary asset? Explain. (a) A retail store, (b) a dentist's office, (c) a manufacturing concern, (d) a bus transportation company, (e) a firm of stock brokers.
2) (a) Give an example of an intangible asset. (b) Why are intangible assets more common in retailing than in farming?
3) How may each of the following firms acquire intangible assets: (a) a department store, (b) a television manufacturer, (c) a movie studio, (d) a manufacturer of a breakfast cereal, (e) an exclusive dressmaker?
4) (a) Explain why the industrial revolution increased the importance of fixed assets. (b) Name five types of businesses in which fixed assets are important. Explain.
5) Show how the circuit flow of current assets, illustrated on page 205, applies to some business; for example, a store you shop in, the place in which you work after school, or your family's business.
6) (a) Explain what is meant by "frozen assets." (b) By referring to the chart on p. 205, explain two ways in which current assets may become frozen. (c) How can frozen assets lead to insolvency?
7) (a) What factors determine how much capital a business will need? (b) Describe three ways in which a business gets capital.
8) A firm has assets worth $100,000, and liabilities to creditors of $30,000. (a) What is its net worth? (b) Why might the business be be sold for $150,000? (c) Why might the business be sold for $40,000?
9) The X Company wishes a loan of $5000. It claims total assets of $60,000. (a) Make a list of five questions a prospective lender might ask. (b) Explain why each question is important.

### III Things To Do

1) Interview a businessman. Find out how he decides how much to invest in the different types of assets he owns.

2) Visit a business in your community. List the assets which are fixed and those which are current. What is the basis for the distinction? Is this business likely to have any intangible assets? Why?

# *LESSON* 28 FINANCIAL STATEMENTS

## The Need for Records

Businesses need records and reports for three major reasons. The first is the requirements of the law. Where there are sales-tax laws, both incorporated and unincorporated businesses must keep records of sales. The federal government and many states have income-tax laws, and businesses must have complete and accurate records to prove that they computed "taxable income" correctly.

A second reason is that systematic records are generally essential for properly carrying on business. Even in the small business, the owner has to handle bills and receipts, orders and cancelations, checks and bank statements, and payments from customers. Larger businesses could not begin to operate without an extensive system of bookkeeping.

A third reason is the need for definite measures of the progress of the business. Even if the businessman could know without formal bookkeeping just where he stands, he would have to arrange this knowledge in standard form, so that outsiders might also see and understand it. If the businessman wishes to buy goods on credit, or to borrow money, sellers and banks will want certain definite information indicating his financial reliability. A *credit-rating agency,* which classifies businesses according to credit standing, may request a financial report. Furthermore, as the business grows in size, and authority is turned over to employees, the businessman will want reports from them so that he can control the various activities of the business.

Some typical questions that interested outsiders, as well as the owners and managers of a business, may ask, are these: What is the value of the property the business owns? What kinds of assets does it own? Who put up the money to acquire them? Is the business making profit? Are the expenses too large?

To answer such questions, it is customary to prepare two regular financial statements. A *financial statement* is a written report following certain customary forms established by accountants. The two most common financial statements are the *balance sheet* and the *profit and*

*loss statement.* The balance sheet shows the financial standing of a business at a particular time, by listing its assets, liabilities, and capital (owned capital or net worth). The profit-and-loss statement (or *income and expense statement*) shows how profits were earned or losses incurred, by setting forth the income and expenses of the business. Although they may be prepared as frequently as the business deems necessary, it is customary to have at least annual reports. The period of one year which a particular business uses as a basis for its reports is called the *fiscal period* or *accounting period.* Most businesses use the calendar year, from January 1 to December 31, but July 1 to June 30 (of the following year) is often used as a fiscal period.

THE BALANCE SHEET

A balance sheet is a standardized statement of a company's financial position at a given time. It may be arranged in two columns, with assets shown in the left column, equal to the sum of the liabilities and net worth shown in a balancing right column. Or, all three parts may be in one column, with the list of assets above the list of liabilities and net worth.

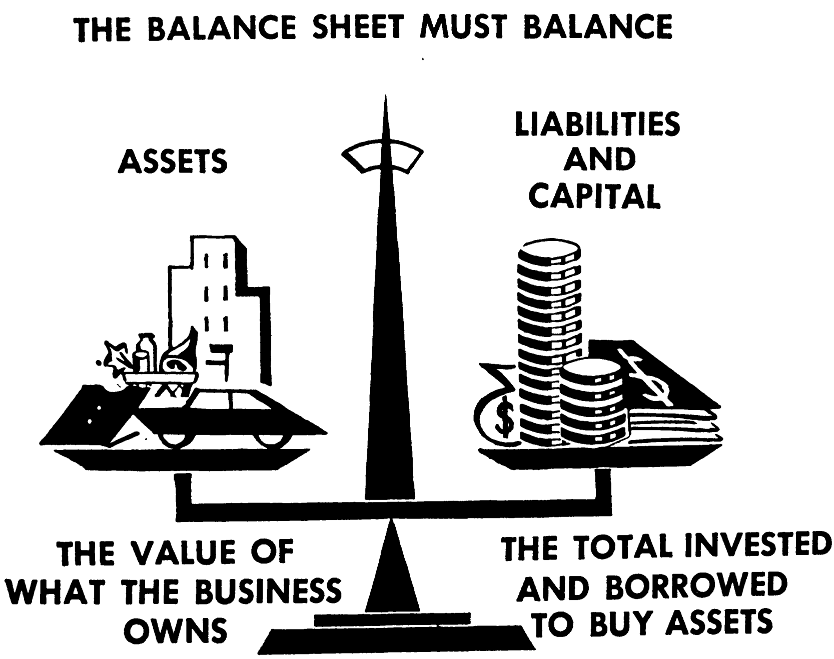



Chart by GRAPHICS INSTITUTE, N. Y.

## Jones Manufacturing
## Balance Sheet

ASSETS

| | | | |
|---|---|---|---|
| *Current Assets* | | | |
| Cash on hand or in banks | | $ 60,000 | |
| Marketable Securities | | 240,000 | |
| Receivables | | 200,000 | |
| Inventories | | 400,000 | |
| TOTAL CURRENT ASSETS | | | $ 900,000 |
| *Fixed Assets* | | | |
| Land and Buildings | $600,000 | | |
| Less: Allowance for Depreciation | 200,000 | $400,000 | |
| Machinery and Equipment | $400,000 | | |
| Less: Allowance for Depreciation | 100,000 | 300,000 | |
| Furniture and Fixtures | $100,000 | | |
| Less: Allowance for Depreciation | 20,000 | 80,000 | |
| TOTAL FIXED ASSETS | | | $ 780,000 |
| *Intangibles* | | | |
| Good will, Patents, Trademarks | | | 320,000 |
| TOTAL ASSETS | | | $2,000,000 |

The balance sheet is illustrated across the top of these facing pages. It is not an accident that the two sides have the same total. It follows from the fact that the right side of the balance sheet shows the claims against the assets which make up the left side of the balance sheet. Since there cannot be property without a claimant, or a claim to property without property, the two sides must be equal. Another way of explaining it is to say that the left side states the values of the business properties, while the right side states the sources from which came the funds to acquire these properties.

The left, or assets, side of the balance sheet classifies the properties of the business as current assets, fixed assets, and intangibles. The basis for the classification was explained in the previous lesson. The fixed assets show both the original value and the present value. *Allowance for Depreciation* is the total of the annual deductions for depreciation, or wear and tear. In the statement shown, the machinery cost $400,000; each year an estimated amount was deducted as depreciation expense, and the total so far deducted amounts to $100,000; the present value is therefore stated as $300,000. Because the annual deduction for depreciation affects the profits, and thereby affects the amount of income taxes to be paid, the method used in estimating it is checked by the government.

COMPANY, INC.
AS OF DECEMBER 31, 1949

LIABILITIES AND CAPITAL

| | | | |
|---|---|---|---|
| *Current Liabilities* | | | |
| Notes Payable | $ 100,000 | | |
| Accounts Payable | 220,000 | | |
| TOTAL CURRENT LIABILITIES | | $ 320,000 | |
| *Fixed Liabilities* | | | |
| Mortgage on Building | $ 250,000 | | |
| Bonds Payable (4% due in 1968) | 150,000 | | |
| TOTAL FIXED LIABILITIES | | 400,000 | |
| TOTAL LIABILITIES | | | $ 720,000 |
| *Net Worth* | | | |
| Common Stock | | | |
| (10,000 no-par-value shares) | $1,000,000 | | |
| Preferred Stock—5% | | | |
| (2000 shares—$100 par) | 200,000 | | |
| TOTAL CAPITAL STOCK | | $1,200,000 | |
| Surplus | | 80,000 | |
| TOTAL NET WORTH | | | 1,280,000 |
| TOTAL LIABILITIES AND NET WORTH | | | $2,000,000 |

Intangible assets—good will, patents, trademarks—according to good accounting practice, must be placed on the books only when paid for, and at no more than the value paid. If a business with net worth of $10,000 is bought for $15,000, the extra $5000 may be entered on the books as good will. Some businessmen feel that it is better to understate good will, rather than exaggerate it; they "write it off," or reduce its value, just as they write off the value of a fixed asset through the deduction for depreciation. Other firms keep good will at full value.

Stating the value of fixed and intangible assets therefore involves estimates and judgments which may vary considerably from business to business. An important service of accounting is to fix standard methods of evaluating and estimating. Without such standards the asset values of firms with large amounts of fixed and intangible assets would become subject to the whim of the businessman.

The right side of the balance sheet lists the liabilities, and capital or net worth. It shows the nature of the claims against the assets. The balance sheet shown here states that $720,000 was borrowed from outsiders; $1,280,000 was the owned capital or net worth, contributed by the stockholders. Net worth is shown to consist of two parts: first is the original investment by those holding its 12,000 common and preferred

shares valued at $1,200,000; second is the reinvested profits or surplus, in the sum of $80,000.

### The Book Value of Shares

The information on the right side of the balance sheet makes it possible to figure out the value of a single share of stock according to the books of the corporation; that is, the *book value* of a share. If preferred stockholders have received their regular dividends, they are not entitled to any further part of undivided profits; therefore the surplus belongs entirely to the common stockholders. The book value of a preferred share is therefore equal to the par value of the share, in this case $100. In the example given, the book value of a common share would be figured as follows:

| | |
|---|---|
| Net Worth | $1,280,000 |
| Subtract par value of preferred shares | 200,000 |
| | 1,080,000 |
| Divide by number of common shares (10,000) | $108 = the book value per share |

The book value of common stock often differs from the market value of a share, because the latter depends mainly upon the attitudes of buyers and sellers in the securities market regarding future developments.

When a corporation sells stock, it is supposed to get an equal value in assets; a share sold by the corporation for $100 is supposed to yield the corporation that much in cash or other assets. Suppose the corporation issues a share shown on the books as worth $100, and receives in exchange assets worth only $60. If the value of the asset received is falsely stated on the books as being $100 and the share is entered as being worth $100, there is an overstatement of value in the amount of $40. We then say that the stock has been "watered." *Watered stock* is stock issued by a corporation at a value which is greater than the value of the asset it acquired in exchange. This works against the interest of other stockholders, for the owners of watered stock are entitled to dividends on the same basis as other stockholders. It also makes the rate of return on net worth seem lower than it really is. Watering stock is generally contrary to law, which requires that stock be issued only against an equal value in assets. The existence of watered stock cannot be detected by reading the balance sheet; rather there would have to be an appraisal of the corporation's assets to see how their actual value compared with their stated values on the books. This problem has arisen sometimes in connection with public regulation of the rates charged by railroads, electric-power companies, and other such businesses.

THE PROFIT AND LOSS STATEMENT

While the balance sheet gives a "still picture" of the assets, liabilities, and net worth at the end of a period, the profit and loss statement provides a kind of "moving picture" of the activities of the enterprise during the period. Thus, the title of the balance sheet will state that it is "as of December 31, 1949," while the title on the profit and loss statement will read "for the year ending December 31, 1949."

The profit-and-loss statement is simply a standardized arrangement and classification of income and expense showing the computation of profit or loss. Actually, reduced to simplest terms, it is the familiar arithmetic formula, Income − Cost = Profit. If a business sells goods for $50,000, and expenses are $30,000, the profit is $20,000.

All the expenses which directly contribute to the cost of the goods manufactured or sold are listed under *cost of goods sold.* Examples of such expenses are materials used, factory wages, and depreciation on production machinery. *Operating expenses* include all other expenses related to the regular business of the company; included are selling expenses, such as advertising and delivery cost, general administrative expenses, such as rent for the office and office salaries, and financial management expenses, such as interest on money borrowed.

Income not directly related to the operation of the business, such as earnings from investments of surplus cash, is shown as *non-operating income.* Expenses not directly related to the operation of the business, such as losses on its investments, are listed under *non-operating expense.*

The statement below is for the same company whose balance sheet was shown on pages 212–213.

JONES MANUFACTURING CO., INC.
PROFIT AND LOSS STATEMENT
FOR THE YEAR ENDING DECEMBER 31, 1949

| | | |
|---|---|---|
| *Sales Income* | | $2,200,000 |
| Less: Cost of Goods Sold | | 1,700,000 |
| *Gross Profit* | | 500,000 |
| *Operating Expenses* | | |
| Selling Expenses | $80,000 | |
| General Administrative Expenses | 50,000 | |
| Financial Management Expenses | 5,000 | 135,000 |
| *Net Profit from Operations* | | 365,000 |
| Non-Operating Income | $10,000 | |
| Less: Non-Operating Expenses | 5,000 | 5,000 |
| *Net Profit Before Income Taxes* | | 370,000 |
| Less: Income Taxes | | 150,000 |
| *Net Profit After Income Taxes* | | $ 220,000 |

Finally, the net profits, which are left after all taxes have been paid, are available for dividends to stockholders. Examination of the balance sheet will show that there were 2000 shares of 5% preferred stock, par value $100, and 10,000 shares of no-par-value common. Each share of preferred is entitled to receive $5 before common stock may receive a dividend. Suppose that the directors vote a dividend of $16 per share of common. The distribution, or allocation, of profits might be summarized as on the statement below:

JONES MANUFACTURING CO., INC.
STATEMENT OF ALLOCATION OF PROFITS
FOR THE YEAR ENDING DECEMBER 31, 1949

| | | |
|---|---|---|
| *Profits After Income Taxes* | | $220,000 |
| *Distributed* | | |
| To Dividends on Preferred Stock (2000 shares, $100 par, 5%) | $ 10,000 | |
| To Dividends on Common Stock (10,000 no–par shares) | 160,000 | |
| To Surplus | 50,000 | $220,000 |

The balance sheet on pages 212–213 has a surplus of $80,000. This means that surplus carried over from previous years was $30,000, to which was added the $50,000 of undivided profits from 1949, bringing the total up to the figure shown.

### ANALYZING FINANCIAL STATEMENTS

A useful device in interpreting financial statements is to change the dollar amounts to percentages. Knowing that current assets make up 45 percent of total assets, or that owned capital (net worth) provides 64 percent of all the funds used in the business, is often more meaningful than the knowledge that the business has $900,000 in current assets and a net worth of $1,280,000. Stating selling costs on the profit and loss statement as 3.6 percent of sales shows that for every dollar's worth of goods sold it incurred over 3½ cents of expense in selling. Likewise, a net profit amounting to $370,000, before taxes, may be a small profit for a large concern or a large profit for a smaller one. Figuring profit as a percentage of sales makes comparison among different businesses more meaningful.

The use of percentages has another value; it may give information about the business without revealing the actual dollar amounts. The firm which publishes the fact that its gross profit was 23 percent of sales is stating a fact without revealing the number of dollars of profit made or the amount of its sales.

Almost any two amounts can be compared for some purpose. The net

profit of the company was equal to almost 17 percent of sales; it was 30 percent of the net worth of the business at the beginning of the year ($1,280,000 at the end of 1949, minus the $50,000 added at the end of the year). These are different ways of computing the rate of profit. Ordinarily the rate of profit is smaller when the profit is compared with sales rather than with net worth. Which rate will be emphasized depends upon what one wishes to prove about the financial standing of the business.


***"This may be fine for your stockholders, Mr. Bullwinkle, but we require a more detailed analysis of your earnings . . ."***

*From George Lichty's "Grin and Bear It"—Courtesy of The Chicago Sun-Times Syndicate*

A comparison which banks may be especially interested in is that of current assets to the current liabilities. This is called the *current ratio,* and may indicate whether the firm is in a position to pay its debts on time. According to the balance sheet of the Jones Manufacturing Company, it had current assets of $900,000 and current liabilities of $320,000, a current ratio of almost three to one. A further evidence of its ability to secure cash quickly is the fact that cash ($60,000) and marketable securities ($240,000) together were one-third of the total current assets; not counting the inventories and receivables, the cash and securities were almost enough to pay off all the current liabilities. Hence the company was in a liquid position. Other measures of liquidity could also be secured by comparing inventories to sales, or to cost of goods sold, which would give varying measures of what is referred to as "turnover."

The comparisons and ratios used will depend upon the purpose for

which the statements are being studied. In large businesses, with branches and departments, ratios by branches or departments give the management clues as to relative efficiency. It must be remembered, moreover, that interpretation of percents and ratios derived from financial statements depends upon the accuracy of the facts recorded in the statements, upon their having been recorded in a standard fashion, and upon the understanding of the principles which operate in that particular business enterprise. A ratio which may be good in one business may be bad in another; 20 percent profit on sales in one business may be too low, while a 10 percent profit on sales in another may be an excellent showing.

Over the years the accounting profession and certain government agencies have done a great deal to standardize procedures for preparing financial statements. This has been of great importance to the community, because effective analysis of financial statements, for whatever purpose, depends on having "the truth, the whole truth, and nothing but the truth." The more complete, accurate, and standardized business records become, the fewer difficulties will arise from differences of opinion as to the values of assets, the amount of profits, and other such questions. These differences of opinion are important in connection with the collection of taxes, regulation of rates charged for transportation and electric power, labor disputes involving the ability of a company to pay higher wages, predictions regarding prosperity and depression, and other questions of public welfare.

## Exercises and Activities

### I Dictionary of Economic Terms

allowance for depreciation
balance sheet
book value
cost of goods sold
credit-rating agency
current ratio
financial statement
fiscal period
income-and-expense statement
net profit
non-operating income and expenses
operating expenses
profit-and-loss statement

### II Questions and Problems

1) "Business starves without its daily supply of figures." Explain.
2) Explain why a business firm's financial statements are important to (a) its managers, (b) its owners or investors, (c) suppliers of its materials, (d) its bank, (e) its employees and their union, (f) the government.

3) Why is it useful to change the dollar amounts on financial statements to percents? Give an example.
4) (a) Show why in the depression period of the 1930's many businesses preferred to quote the "rate of profits on net worth," whereas in the 1940's they quoted the "rate of profits on sales." (b) How does this illustrate the "propaganda value" of accounting?
5) (a) Why is the "current ratio" on the balance sheet useful to credit-rating agencies? (b) Suggest one other ratio that may be of use.
6) (a) Compare the meanings of "par value," "market value," and "book value." (b) Explain why book value and market value may differ.
7) (a) What are the possible advantages to a corporation of watering its stock? (b) What information not shown on the financial statements is needed to check whether stock is watered? (c) Why may watered stock be considered undesirable?

III THINGS TO DO

1) Examine the financial statements of your student organization. How does it compare with the statements shown in this lesson?
2) Collect samples of financial statements in the newspaper or in reports and pamphlets of business firms.
3) Read and report on *Small Businessman and His Financial Statements,* a pamphlet issued by the U.S. Department of Commerce (1948), or *Managing Farm Incomes.* Both are obtainable from the Superintendent of Documents, Washington 25, D.C.

# *UNIT* 6

## BUSINESS COSTS AND PRICES

*29* DIRECT AND OVERHEAD COSTS

*30* MASS PRODUCTION AND COSTS

*31* OVERHEAD COSTS AND COMPETITION

*32* THE COST OF DISTRIBUTION

*33* THE MARKET: SUPPLY, DEMAND, AND PRICE

*34* PRICING IN AN ORGANIZED MARKET

*35* PRICE AND EQUILIBRIUM

## *LESSON* 29 DIRECT AND OVERHEAD COSTS

THE BASIC COSTS OF DOING BUSINESS

There are men who make a living by peddling goods—shirts, ties, shoelaces, razor blades, and other things—from door to door. For them the problem of costs is very simple. They know what they have paid for each item; whatever they get above that is profit. The storekeeper who handles the same kind of merchandise has a more complicated set of costs. Not only does he have to pay for the merchandise, but every month he must pay rent. If he owns a building, instead of paying rent he has to pay property taxes and the expenses of maintaining and heating the building. Every week wages have to be paid to the clerks, and every month there are bills for electricity and for the telephone. In order to build up his business, he spends money for advertising in the local newspaper. There are frequent expenditures for maintenance, such as washing the windows and repairing the fixtures. Since the fixtures in the store wear out after a certain number of years, the owner of the business sets aside some money each year for depreciation. When it is necessary to put in a big stock of merchandise for a seasonal rush, the owner may borrow some money from his bank; the interest charged for the loan is another cost. These are the typical costs which are to be found in any business, large or small, wholesale or retail, manufacturing, farming, or selling.

OVERHEAD COSTS AND DIRECT COSTS

The peddler we mentioned before has only one cost to worry about, the amount he paid for his merchandise. If business is bad, he can dispose of the merchandise for whatever he can get; the most he can ordinarily lose is part of the money he paid for the merchandise.

The storekeeper's risk is much greater because he has many kinds of costs to cover, besides the cost of the merchandise. His problem is that some of these costs are *overhead costs.* Overhead (*fixed*) costs are costs the total of which remains about the same, regardless of the amount of business done. The rent must be paid every month, whether business is good or bad. The neon sign and the lighting fixtures use up the same amount of light in a bad month as in a good month. If there are installment payments to be made or interest payments to the bank

or property taxes, these must be paid whether the volume of business is large or small.

Some of the storekeeper's costs are more flexible, or easier to control. When business is good, the owner of the store orders larger amounts of merchandise, thus increasing his inventory cost. In slow times he reduces his inventory cost by keeping smaller stocks of goods on his shelves. During the rush seasons he hires extra clerks, increasing his labor cost. When business slows down, he lays off the workers, reducing his labor cost as much as possible. We apply the name *direct* (*variable*) *costs* to those costs the total of which varies with the volume of business.

Overhead costs appear in a business for two reasons: because of the nature of the business, and because of contract arrangements. A business usually has certain costs which it cannot reduce below a minimum amount, regardless of the amount of business, unless it wishes to go out of existence. A coal-mining company must keep pumping crews working in the mine even when no mining is being done there—unless it is willing to abandon the mine. A storekeeper who closes his store during the summer has to pay rent for that time in order to continue the business in the fall. No matter how slow business is in a department store, the elevators must be kept running, lighting and heating must be provided, and a minimum staff of salespeople must be on the floor.

Overhead costs also arise when a business firm makes a contract, oral or written, which forces it to continue a particular expenditure regardless of the volume of business. If a company signs a three-year contract with a worker with a salary of $50 per week, the company has added to its overhead costs by $50 a week until the contract expires. On the other hand, if the company hires a worker without any contract, when business slows down the company may lay him off, with perhaps a required amount of notice. In this case, the worker's salary is a direct cost to the firm. When the company rents some extra office space on a month-to-month basis, this rent is a direct cost because it can be eliminated when business slows down. Should the company sign a lease for an extended period, then the added rent becomes part of the company's overhead costs until the end of the lease.

There are borderline cases in which it is difficult to draw a sharp distinction between direct and overhead costs. This is especially true of such costs as labor, inventory, power, and maintenance. There are minimum amounts of these items which must be used and paid for, regardless of the amount of business being done, and there are also additional amounts of these items which must be added as the volume of business increases. The minimum amounts should be regarded as overhead costs; the additional amounts as direct costs.

OVERHEAD COSTS AND PROFITS

In order to make a profit the businessman must take in enough money not only to pay for the direct costs, such as merchandise and labor, but also to cover the overhead costs of the business. No matter how little business he does, the overhead expenses must be paid as usual. The smaller the overhead costs, the less financial damage is caused by a drop in business. In many businesses, however, overhead costs are relatively large and cause the businessman to lose substantially when business is bad.

Why, then, does a person go into a business with high overhead costs? By running a business with high overhead costs, he hopes to make more money than he could by operating one with low overhead costs. The high costs may result from paying a high rent for a desirable location for a store or for a modern, efficient factory building; or from borrowing money to expand the business. Whatever the nature of the overhead expense assumed by the businessman, his purpose is always to increase the volume of business or to get a more profitable kind of business.

If the businessman increases his overhead costs in order to get more business, then how can he make more profit? The answer to this question lies in the effect of changes in volume of business on *unit cost* and *total cost*. Total cost equals the total direct cost plus the total overhead cost. As the volume of business changes, the total direct cost changes proportionately. The result is that, as the volume of business changes up or down, the direct cost per unit remains about the same. But total overhead cost remains the same. Hence the overhead cost per unit declines proportionately as the volume of business rises; and rises proportionately as the volume of business decreases. This is illustrated in the following figures:

| a | b | c |
|---|---|---|
| *Volume of Business* | *Direct Cost per Unit* | *Total Direct Cost* ($a \times b$) |
| 25,000 units | $2.00 | $ 50,000 |
| 50,000 " | 2.00 | 100,000 |
| 100,000 " | 2.00 | 200,000 |

| d | e | f |
|---|---|---|
| *Total Overhead Cost* | *Overhead Cost per Unit* ($d \div a$) | *Cost per Unit* ($b + e$) |
| $100,000 | $4.00 | $6.00 |
| 100,000 | 2.00 | 4.00 |
| 100,000 | 1.00 | 3.00 |

Increasing the volume of business, therefore, tends to increase profits in two ways. Additional sales normally mean more profits. Also, the in-

creased volume means a lower cost per unit, because overhead cost per unit declines, as total overhead cost is spread over more units. An example of this effect is given in the following graph. The lower the cost per unit, the lower the price at which the article can be sold, and the greater the possibility of getting still more business and still more profit.

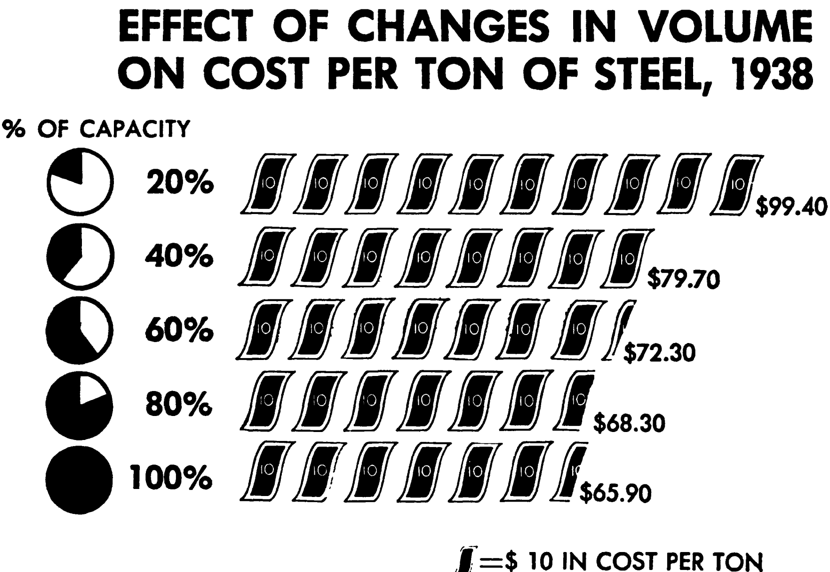



Chart by GRAPHICS INSTITUTE, N. Y.

**Doubling output from 20% of capacity to 40% reduced cost by $19.70 per ton (from $99.40 to $79.70). Doubling again from 40% to 80% of capacity reduced cost by an additional $11.40 per ton. Cost at capacity (100%) was about $\frac{2}{3}$ of cost at 20% of capacity. (Data from *Structure of the American Economy*, Part II, National Resources Planning Board, June, 1940)**

Thus far we have assumed that as the volume of business changes, total overhead costs remain the same and direct cost per unit remains the same. In practice this assumption may not always be true. When drastic changes in the volume of production, or in methods of production, are made, the change in direct cost per unit can be strikingly large. As the scale of operations grows, buying in large quantities may reduce the unit cost of raw materials. The introduction of better machinery, and more systematic methods of production and selling, reduces the labor cost per unit. This is particularly true when a switch is made from hand methods to mass-production methods, as in the automobile, radio, and electrical industries in the 1920's. Ordinarily, however, the direct cost per unit does not change, or changes very gradually. Overhead

cost per unit, on the other hand, changes inversely with the volume of business.

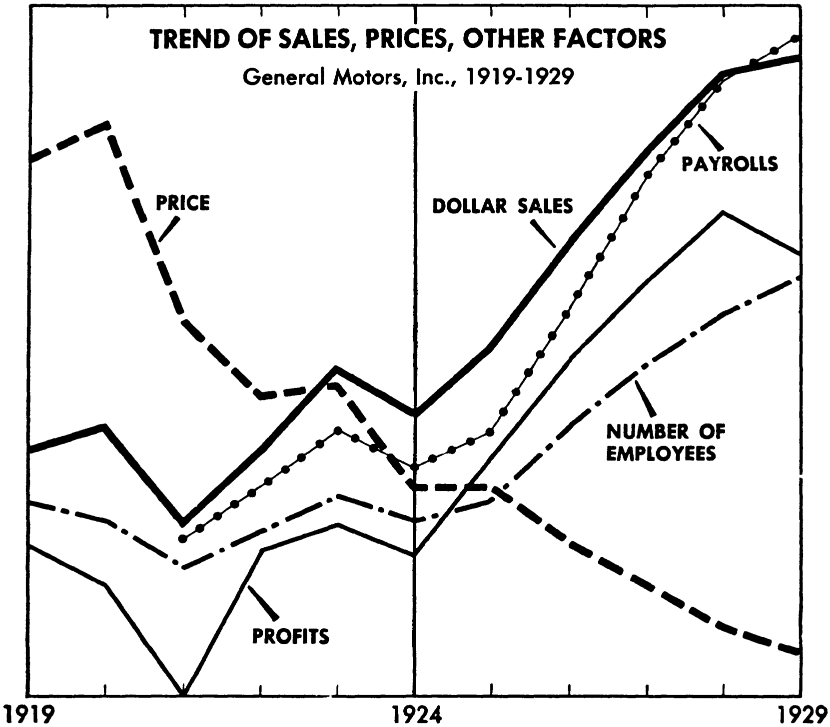
Nor, as has been stated, is total overhead cost absolutely and permanently fixed. When a firm increases its *capacity* by getting more space, plant, or equipment, its total overhead costs increase. If it becomes advisable to reduce capacity, and the reduction is made, total overhead costs decline. "Capacity" means the amount of goods which can be produced, or the amount of business that can be handled, with a given amount of plant and equipment. Even when there is no change in capacity, total overhead costs can be changed from time to time. If business is bad for a long time, the storekeeper may persuade his landlord to reduce the rent for the remainder of the term of the lease. In good times, when a lease expires the landlord may raise the rent. When business is good, a firm may increase its debts in order to expand. If business turns bad, the firm may make a settlement with its creditors in order to cut the total overhead cost. Over the long run, as business grows or shrinks, the total overhead cost may grow or shrink accordingly. In the short run, however, total overhead cost tends to remain the same.

### Overhead Costs and Mass Production

Overhead costs make up one of the most important features of the modern industrial system. The development of large-scale methods of production and distribution has forced business firms to operate with large amounts of overhead expenses. The growth of overhead costs has had both good and bad effects. The good effects are illustrated in the chart on the following page.

The story told in this chart has been characteristic of a large part of American industry. The growth of overhead costs has been offset by steadily increasing volume of production so that the overhead cost per unit has become smaller. As the cost per unit dropped, it was possible to sell goods at a lower price, thereby increasing the volume of sales and of profits. Larger profits have enabled manufacturers to pay higher wages to their workers, who have used this added income to buy more goods. The increased demand means a greater volume of business, which makes possible still lower overhead cost per unit, still lower price, still more sales, still more profits, and so on—a continuing spiral of lower costs, more business, higher wages, and more real income for all the groups in the community. As will be seen in the next lesson, it is difficult to tell how far this spiral effect can be carried.

Overhead costs have also created some difficult problems. The spiral effect described above depends on two conditions. One condition is that




Here is an illustration of the beneficial effects of mass production, from the records of one of America's great corporations. Note that as volume of sales mounted (solid line), prices (heavy dotted line) declined. Note, too, that this reduction in prices was accompanied by rising payrolls, employment, and profits. Mass production has meant lower cost per unit, lower prices, and rising income payments. (Adapted from General Motors pamphlet, 1939)

consumers continue to expand their purchases to absorb all that is being produced. If the volume of sales does not increase sufficiently to offset the increase in total overhead cost, then there will be losses. The second condition is that competition should not force the selling price so low that business, despite the large volume of sales, would become unprofitable. Moreover, the lower the selling price, the higher is the break-even point and the more volume needed to show any profit. In the boom period of the 1920's many business firms expanded their capacity and their overhead costs. Then in the 1930's they were unable, when lack of sales forced them to operate below capacity, to cover costs. To avoid these dangers businessmen strive constantly to increase volume by sales efforts, advertising, cutting prices, or diversifying products and brand names.

## Exercises and Activities

### I Dictionary of Economic Terms

capacity
direct or variable cost
overhead or fixed cost
total cost
unit cost

### II Questions and Problems

1) (a) Which items in the family budget can be classified as overhead costs and which as direct costs? Explain the basis for the classification. (b) What connection is there between overhead costs and the saying, "Two can live as cheaply as one"?
3) Classify each of the following costs as "direct" or "overhead" and explain your classifications: (a) payroll of factory workers, (b) wages of elevator operator in apartment house, (c) payroll of major-league baseball club, (d) rent paid for store as percentage of volume of business, (e) real estate taxes, (f) salary of manager of store, (g) depreciation of machinery, (h) power used to run machinery in factory, (i) coal used by gas company to produce gas, (j) feed for horse used on farm, (k) feed given to hogs raised for market, (l) installments payable monthly on loan from bank, (m) royalties payable to inventor.
4) Gandhi, the great Indian leader, urged the people of India to go back to the spinning wheel and the hand loom, and to discard modern factory methods. If the people of India had adopted his idea, what would have been the effect on costs of producing clothing?
5) The manufacturer of a toy automobile found that the first automobile cost him \$10,000, while the 10,000th one cost him only \$1.00. Explain.
6) The X Fountain Pen Company's books show the following figures.

Change from Preceding Year

| | 1930 | 1931 | 1932 |
|---|---|---|---|
| Sales | −20% | −38% | +140% |
| Net Profit | −46% | −76% | +1230% |

The Y Fountain Pen Company's books show the following figures.

Change from Preceding Year

| | 1930 | 1931 | 1932 |
|---|---|---|---|
| Sales | −20% | −38% | +140% |
| Net Profit | −24% | −47% | +207% |

How do you explain the difference in the fluctuations of the net profits of the two companies?

7) Explain these statements: (a) Mass production tends to increase overhead costs, yet results in lowered unit cost. (b) Overhead costs tend to increase the use of mass production methods. (c) Mass production depends on mass demand.

III Things To Do

1) Draw a cartoon illustrating the idea that the volume of sales spreads overhead costs.
2) Interview a businessman and obtain from him a list of the different types of his overhead and direct costs.

# LESSON 30 MASS PRODUCTION AND COSTS

### Why Costs Differ From One Firm to Another

Years ago an enterprising business firm opened a furniture store in an old stable. The store attracted many customers by advertising, "Our prices are lower because our rent is lower!" At the same time a great department store, located on the highest-rent street in the same city, claimed that it was underselling all the other stores. Could both these claims be right? As we have seen in the previous lesson, the unit cost of an article depends on the volume of business. Which firms can produce and sell more cheaply, the large firm with high total costs, or the small firm with low total costs? This is a difficult question to answer because there are many reasons why one firm may have higher or lower costs than another.

One important factor lies in the differences in the abilities of individual owners and managers of business enterprises. A successful businessman must have technical knowledge, ability as an organizer, wisdom in handling employees, cleverness as an advertiser and salesman, energy and drive to work hard when business conditions are difficult, and the willingness to take risks. Businessmen vary greatly in these qualities. Such differences in their capabilities are responsible for substantial differences in their costs of doing business.

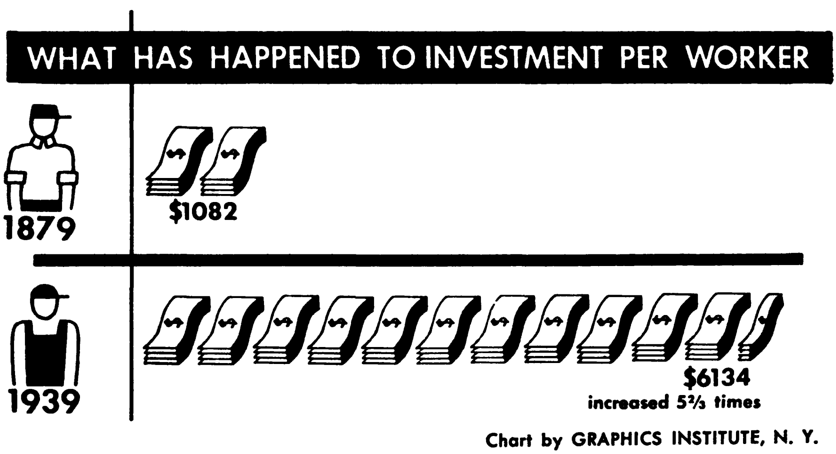
Costs are also affected by the availability of the various factors of production. Southern textile mills have an advantage over Northern mills because of lower labor cost. The millinery factories in New York City can operate at a lower cost than most other millinery factories because they are in a millinery center, where the right kind of labor, machinery, and materials are available in adequate quantities and at reasonable prices. The chemical industry of Germany once could undersell

the chemical industries of Great Britain and the United States because the Germans had superior technical knowledge. Factories located near Niagara Falls have cheap power as a means of reducing production cost. Businesses located where cheap labor, technical skills, complex machinery, special raw materials, cheap power, or good transportation and markets are available have an advantage over businesses less fortunately located.

### The Meaning of Large-Scale Operations

In the modern business world, cost has been greatly affected by the development of large-scale production and merchandising. These large-scale operations are made possible by the accumulation of large amounts of capital. When the United States Steel Corporation was founded in 1901, through the combining of a number of steel companies, it had more than a half-billion dollars in capital. More recently the American Telephone and Telegraph Company has been able, through the sale of securities, to increase short-term capital by several hundred million dollars in a single year. These are extreme examples, but we have many firms with capital funds running into millions, even tens of millions, of dollars. The chart below shows how the amount of capital needed in manufacturing has grown in the sixty years from 1879 to 1939.

This large amount of capital is made necessary by the fact that large-scale production is *roundabout production.* This means that, in order to get a continuous flow of consumers' goods, we must first create a




**The average worker in 1939 had 5½ times as much capital equipment at his disposal as the average worker sixty years before. This is a major factor in explaining the increase in labor's ability to produce.**

large amount of producers' goods: factories, machinery, parts, materials, and transportation equipment.

Large-scale production also requires a long period of planning and preparation before the production of goods is begun. The production of a new model of a radio, for example, cannot be started hurriedly. For months the company's engineers will explore various ideas for improving the product. A separate blueprint has to be made for every part of the new radio. From these designs working models are prepared and tests are made. Meanwhile, the company may have to arrange for bank loans or sales of securities to provide capital to finance the production of the new model. A selling campaign may be planned even before the product is on the market. Raw materials must be bought and stored, and the right kinds of workers hired. Finally, the machines are "tooled" from the blueprints, and begin to turn out the new model. Months pass from the time when the planning was begun until the first units of the product come off the assembly line ready to be sold.

A basic feature of large-scale production is *division of labor,* or *specialization.* Each process is divided into a number of simple operations. These operations can be learned quickly and make it possible for each worker to follow an exact routine all day long and every day. This division of labor has been carried to such an extreme that many of the operations in the production process are automatic and can be performed by workers arranged in an assembly line, or by automatic machinery. Industrial engineers, or efficiency experts, study each process for the purpose of discovering how it can be done with greatest efficiency and lowest cost.

Large-scale production also makes possible *geographic division of labor,* or *territorial specialization.* Operations can be divided among different plants, with each plant located where it can be run most efficiently: furnaces and mills can be built near mines, parts-producing plants where there is an ample supply of labor, and assembly plants near railroad centers and ports, or even in foreign countries.

Large industrial firms can afford to set up expensive laboratory facilities for research, in order to improve the product, reduce production costs, and develop new products. The amount of waste materials may be large enough to justify investing capital in plant and machinery for their conversion into *by-products,* extra products which are incidental results of the production of the main products. The meat-packing industry produces hundreds of by-products, such as fertilizers, glues, soap, brushes, buttons, and medicinal preparations. Separate plants for the production of by-products are common in the food, chemical, and petroleum industries.

Industrial research has been an important factor in the development

*Kaiser-Frazer Corp.*

**The assembly line technique has become identified with mass production methods. Pictured is part of the assembly line in a large automobile plant. How does the success of this technique depend upon the standardization of parts?**

of another characteristic of large-scale industry—*diversification of product;* that is, the production of a variety of products by a single company. A study made in 1937 showed that the 50 largest manufacturing companies in this country were producing 4085 products, an average of 80 products per company. The range was from 6 to 302 products per company.[1] This diversification of product is due, to a large extent, to the development of by-products and new products in industrial laboratories. An electrical-appliance manufacturer, through experimentation, developed air-filtering machines and sterilizing lamps. A petroleum-refining company became a producer of mineral oil. A manufacturer of automobiles went into the production also of refrigerators and Diesel motors.

We often speak of *scientific management* as a characteristic of large-scale business. Scientific management is a general term which includes all the factors described above—extreme division of labor, research, and diversification of products. It includes also mass buying of raw materials according to exact specifications. The hiring of workers and the settling of labor-management problems are handled by a personnel department of experts specially trained in psychology, economics, and labor problems. Advertising, selling, financial activities, and all other phases of the work of the company are placed in the hands of specialists.

### Benefits and Problems of Mass Production

These mass-production methods yield some important economic benefits. The roundabout method of production and division of labor make it possible to increase greatly the volume of production of goods and services. If the long-range planning required by mass production is efficiently done, it not only reduces the unit cost, but also helps to improve quality and bring more variety. For the businessman this may mean more sales and larger profits. Moreover, the diversification of product makes it easier to get business, and spreads the company's risk over a larger number of products. It also helps to reduce the company's cost per unit and thus makes it possible to undersell competitors.

The consumer gains, too, because mass production makes it possible for the businessman to lower the prices of goods. Industrial research brings to the consumer a succession of new products. As workers, too, people benefit from mass production, since the high degree of specialization makes it easy to learn a new kind of work and to shift from one job to another.

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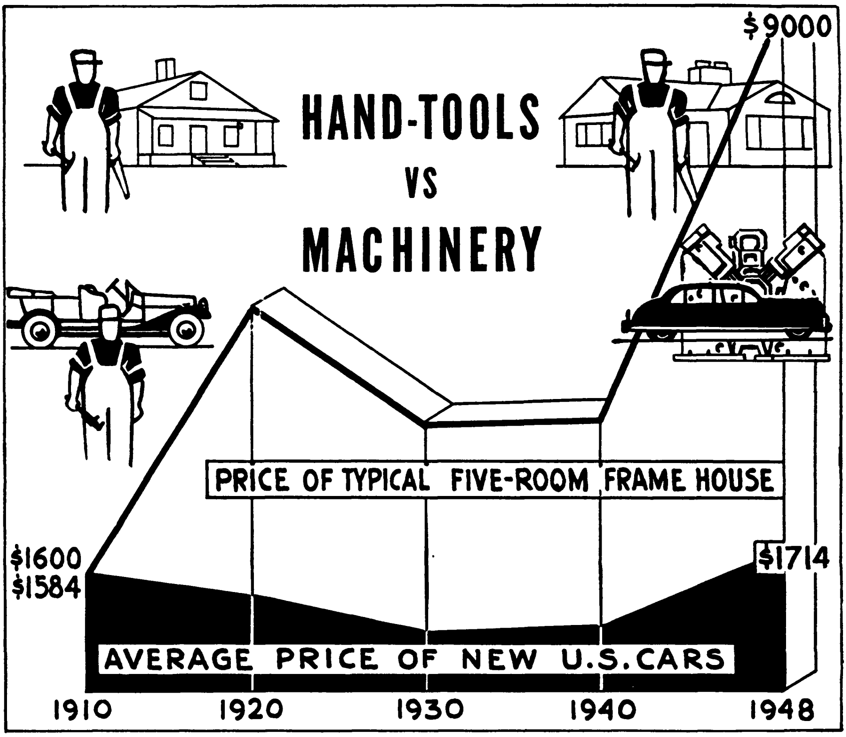
[1] *The Structure of American Industry,* TNEC Monograph No. 27, 1941, pp. 606, 648–659.

These benefits of mass production and distribution have, however, been accompanied by serious problems. Because mass production requires large amounts of capital, business risks have increased and opportunities for small businessmen have shrunk. There is also the constant danger that competitors will get ahead in technical knowledge and equipment. Manufacturers must therefore be prepared to install




*Automobile Manufacturers Association*

A much improved car cost about the same in 1948 as a poorer one did in 1910. Housing costs in 1948 were much higher than in 1910. One reason was the continued use by the housing construction industry of individual assembly by hand tools, instead of mass production.

new machinery, and sometimes build entirely new plants. Thus, machinery becomes obsolete at a rapid rate, and the rate of depreciation increases.

From the point of view of the workers, automatic machinery and assembly lines have reduced much factory work to a semiskilled and unskilled level. There is less physical strain but greater monotony and possibly more nervous tension. This has been offset by the shorter workday and longer week ends, as well as by higher wages and better health services.

## Effect of Large-Scale Operations on Cost

To what extent have large-scale business operations actually brought about lower costs of goods? Is there a limit to the process of lowering costs by enlarging the scale of operations? There is no conclusive answer to these questions, because methods of analyzing business costs are still inadequate.

Studies have been made in the cement, iron-and-steel, farm machinery, petroleum, sugar-refining, milk and milk-products, flour-milling, and automobile industries.[2] The authors of these studies asserted that no clear proof was established that large plants have a lower production cost per unit, or give a higher rate of return on invested capital, or pay higher wages than the smaller plants. They offered several possible explanations for the apparent failure of large-scale business to achieve all the advantages claimed for it.

First, many business firms have enlarged their operations by buying out competitors, for the purpose of eliminating competition, or for making profit out of financial arrangements, rather than for the purpose of increasing efficiency and reducing costs.

Second, there seems to be a limit to the cost-reducing effect of mass production. Beyond a certain point, larger size does not necessarily bring lower cost per unit. The larger the plant, the farther the management is removed from actual operations. This makes it difficult for management to check operations and keep them at the height of efficiency. This difficulty of supervision seems to be especially true when the scale of operations extends beyond a single plant to a group of plants, and when there is considerable diversification of product.

Third, the public may not be getting as much benefit from the research facilities of big business as is possible. When large business organizations develop in an industry, there is frequently a lessening of competition. As a result, the spur to experimentation and introduction of new methods may be dulled. From a financial viewpoint, the large producer may prefer to slow down the introduction of improvements in order to avoid losses from too rapid obsolescence of machinery.

Fourth, large-scale business is often controlled by *absentee directors,* men who control the policies of a particular company but do not give a major part of their time to the management of the company. The directors of large corporations are usually men with financial interests in many businesses; they have to rely to a large extent on the work of their subordinates. The subordinates who are on the scene every day are not,

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[2] *Relative Efficiency of Large, Medium-Sized, and Small Business,* TNEC Monograph No. 13, 1941. See also Twentieth Century Fund, *How Profitable is Big Business?* 1937.

however, in a position to make decisions on major policy. Such a system may lead to inefficiency.

On the other hand, some economists claim that such conclusions are not justified, because, they point out, the statistical data regarding costs of production in large and small plants are inadequate.[3]

A middle position has been taken by a noted authority, Professor Corwin D. Edwards, who makes a distinction between the efficiency of a single large plant and the efficiency of a large firm operating more than one large plant. He says, "The case for preserving the large industrial establishment on grounds of efficiency is overwhelming. . . . The case for preserving the large business that contains more than one establishment is less persuasive. . . ."[4]

## Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | |
|---|---|
| by-product | geographic division of labor |
| diversification of product | mass production |
| division of labor (specialization) | roundabout production |
| scientific management | |

II QUESTIONS AND PROBLEMS

1) State three reasons why costs differ among producers of the same article.
2) State five advantages of large-scale production.
3) State three problems created by large-scale production.
4) State four reasons which may hinder large-scale business from fully developing its advantages.
5) Explain how each of the following quotations illustrates certain characteristics and problems of large-scale production: (a) "As relentless as fate, the endless belt moved. Knots of workmen on the assembly line . . . nuts were tightened, parts were fastened . . . same operation repeated again and again." (b) "Not counting the engine or special equipment such as guns or radio, a light tank has 17,000 parts. To make these parts a set of 2800 blueprints is required. Into such a tank go thousands of parts which must be machined to dimensions which must not vary more than 5/10,000 of an inch. . . . American Car and Foundry were planning production for six months before it received its first tank order. Seven months later the first tank was finished." (c) "In the last eight years the Ford Company scrapped 46% of its entire plant. . . . The equip-

[3] J. S. Bain, "Price and Production Policies," *Survey of Contemporary Economics*, Blakiston Co., 1948, p. 141.

[4] Corwin D. Edwards, *Maintaining Competition*, McGraw-Hill Book Company, 1949, pp. 111–118.

ment scrapped was not broken, or obsolete in the ordinary sense. . . . It was not waste—it was economy. . . ."

6) "The American workingman is the highest-priced workingman in the world because American management has furnished him with the best working equipment in the world. The American workingman earns more money, owns more property, uses more goods, and is able to save more by his thrift than any other, not because he works harder or works long hours, but because his better equipment under expert direction enables him to produce more. Progressive managers discovered long ago that it is cheap labor that costs most, and expensively equipped and highly paid labor is in every way the most economical to employ." (a) Summarize the quotation in your own words. (b) What evidence could you offer in support of the above statement? (c) Would labor leaders accept this statement?
7) What reply might the head of a large business give to questions raised about the efficiency of big business?
8) Explain the distinction which Professor Edwards makes in the quotation ending the text on page 237.
9) How does the graph on page 235 illustrate the text on pages 89–91?

III THINGS TO DO

1) Read and summarize the pamphlet *Power, Machines, and Plenty* (Public Affairs Pamphlet No. 142, Public Affairs Committee, 1948), and *Men and Machines* (*You and Industry Series*, National Association of Manufacturers), regarding the effects of machinery on production and costs.
2) On the basis of your observations in your community, summarize the differences between large-scale and small-scale methods in factories, stores, or farms.

# *LESSON* 31 OVERHEAD COSTS AND COMPETITION

## COSTS, VOLUME, AND PROFITS

In 1945 John Gordon organized the Pyramid Chemical Company for the purpose of manufacturing a spot remover for clothing. He rented a loft, installed machinery and office equipment, and hired the necessary labor. His plant could produce 100,000 pint bottles of spot remover per year if all the machinery were operated fully. He adopted the brand name "Wondakleen." The firm had yearly overhead costs amounting to $15,000—mainly rent, maintenance, office help, advertising, monthly payments for machinery. The direct cost per pint bottle —labor and materials—was 30 cents.

Mr. Gordon decided to charge $1.00 per bottle for the spot remover, because that was about the usual price for such a product. At that price he sold 30,000 bottles during the year 1945. Since his total overhead costs were $15,000 the overhead cost per unit became 50 cents. The financial results were as follows:

| a | b | c | d | e | f | g | h |
|---|---|---|---|---|---|---|---|
| Year | Selling Price | Sales Vol-ume | Overhead Cost per Unit ($15,000 ÷ c) | Direct Cost per Unit | Aggregate Cost per Unit (d + e) | Unit Profit (b − f) | Total Profit (c × g) |
| 1945 | $1.00 | 30,000 | .50 | .30 | .80 | .20 | $6,000 |

Since sales were less than one-third of capacity, the company decided to increase volume by cutting the price. At 90 cents the firm sold 50,000 bottles in 1946, with the following results:

| Year | Selling Price | Sales Vol-ume | Overhead Cost per Unit | Direct Cost per Unit | Aggregate Cost per Unit | Unit Profit | Total Profit |
|---|---|---|---|---|---|---|---|
| 1945 | $1.00 | 30,000 | .50 | .30 | .80 | .20 | $ 6,000 |
| 1946 | .90 | 50,000 | .30 | .30 | .60 | .30 | 15,000 |

By increasing the volume of sales, the company had reduced the overhead cost per unit so much that the unit profit, or margin of profit, was higher at a selling price of 90 cents than it had been at the selling price of $1.00. An increase in volume of 66⅔ percent caused total profits to increase by 150 percent.

For 1947 Mr. Gordon was tempted to lower the selling price still more in order to get more volume. From his analysis of the market, however, he was uncertain as to whether the drop in price would add enough volume to increase profits. He finally decided against a price decrease. During the year new competition appeared in the field, and the sales of Wondakleen declined sharply, with the following results:

| Year | Selling Price | Sales | Overhead Cost per Unit | Direct Cost per Unit | Aggregate Cost per Unit | Unit Profit | Total Profit |
|---|---|---|---|---|---|---|---|
| 1945 | $1.00 | 30,000 | .50 | .30 | .80 | .20 | $ 6,000 |
| 1946 | .90 | 50,000 | .30 | .30 | .60 | .30 | 15,000 |
| 1947 | .90 | 25,000 | .60 | .30 | .90 | none | none |

The drop in volume had raised the overhead per unit to such a point as to eliminate profit entirely. To meet the new competition, the Pyramid Company in 1948 cut the price sharply to 70 cents. This change enabled the company to rebuild its volume to a new peak of 60,000. The financial results were much better than in 1947, but not so good as in 1946. The lower selling price had not caused a sufficient rise in the

volume of business, and the unit profit, as compared with 1946, dropped considerably. The results for 1948 were as follows:

| Year | Selling Price | Sales | Overhead Cost per Unit | Direct Cost per Unit | Aggregate Cost per Unit | Unit Profit | Total Profit |
|---|---|---|---|---|---|---|---|
| 1945 | $1.00 | 30,000 | .50 | .30 | .80 | .20 | $ 6,000 |
| 1946 | .90 | 50,000 | .30 | .30 | .60 | .30 | 15,000 |
| 1947 | .90 | 25,000 | .60 | .30 | .90 | none | none |
| 1948 | .70 | 60,000 | .25 | .30 | .55 | .15 | 9,000 |

These figures illustrate the problem which faces businessmen in general, as they try to get business or to hold on to the business they already have. How can they find that combination of price, sales volume, and overhead costs which will give them the greatest amount of profit? Only by experimenting with various policies regarding prices and costs, and seeing what volume of sales they get, can they decide which policy is best for their particular business. Moreover, these policies have to be varied to meet new competitive situations or changing economic conditions.

Notice the central importance of volume in determining the cost of an article. The more units sold, the smaller the part of the overhead costs each unit has to pay for; the fewer units sold, the greater the part of the overhead each unit must carry. The businessman does not actually know what his merchandise is going to cost him per unit, until after the season, or year, has come to an end. Only then can he calculate his cost per unit and see whether he has made any profit.

In practice, of course, the businessman adds to the direct cost a given amount or percentage so as to cover the overhead cost per unit and provide a margin of profit. This is called the "markup." He cannot be certain in advance that this markup is large enough. If it is too low, he may do a large volume of business; but he will not make enough profit, or may even lose money. If his markup is too high, he may have a high unit profit, but may not do enough business to make a satisfactory total profit. By trial and error the businessman tries to determine the best markup for his business as a whole and for each of the articles he sells.

### Product Differentiation and Diversification of Products

Although the Pyramid Chemical Company had recovered fairly well in 1948, Mr. Gordon was worried. He did not want to repeat the experience of 1947, when a drop in volume had prevented him from making any profit. Moreover, the experience of 1948 showed that, in order to get much additional business, he might have to cut prices drastically. But cutting prices might reduce the unit profit still more so that total

profits would be endangered. There was a solution, however, for this problem: perhaps he could hold on to his present volume of business at the existing price, and get additional business at a reduced price. That raised two questions: First, how could he cut prices on part of his merchandise and not on the rest of it? The answer to this question was that he could sell part of his production at a lower price but under a new name, "Mirakleen." The sales of Mirakleen would not interfere with the sales of Wondakleen, because of the difference in name; especially if the new product were sold through different outlets, such as bargain basements and cut-rate stores.

Second, how much could the firm afford to cut the price to get added business? The answer was that the firm could sell the new product at any price above 30 cents (the direct cost per unit) and make a profit. Here was Mr. Gordon's figuring:

Wondakleen sells for 70 cents a bottle.

Direct cost is 30 cents per bottle.

This leaves 40 cents per bottle to cover overhead costs.

Total overhead costs are $15,000.

$15,000 divided by 40 cents equals 37,500. This is the number of bottles which must be sold for the firm to break even.

Since sales of Wondakleen for 1948 were 60,000, at a price of 70 cents, this product can safely be charged with the total overhead costs.

Mirakleen will have direct costs of 30 cents per bottle, but will have no overhead cost per unit.

Therefore, as long as sales of Wondakleen stay at 60,000 (at 70 cents each), any price for Mirakleen above 30 cents will bring in a profit. At 49 cents, for example, Mirakleen will bring in a profit of 19 cents per unit.

Mr. Gordon's calculations help to illustrate another important effect of overhead costs on business policies. In striving for increased volume, business firms frequently sell various portions of the same product at different prices by varying the form of the product, or the time or place of its sale. The differences in prices may be much greater than the differences in quality or cost. This practice is possible because once the total overhead costs have been covered by the volume of business already on hand, additional business can be sought at any price above the direct costs, plus added overhead costs, which may come from enlarging the capacity of the plant or the sales activities.

The policy of varying the prices of goods and services in order to reach different kinds of buyers is shown in many ways in the business world. A flour mill may pack the same, or almost the same, flour under three different names, at three different prices, to reach housewives of different income levels and buying habits. For similar reasons, railroads run Sunday excursions at reduced rates, telephone companies

charge lower rates for calls made in the evenings and on Sundays, and theaters vary their prices according to the time of day. All these cases are examples of product differentiation which is being used to get a larger sales volume.

Additional volume for the purpose of offsetting overhead costs can also be secured through *diversification of product.* The more products a firm handles, the greater flexibility it has in meeting competition. The items on which there is less competition can be sold with a larger margin of profit and can take care of most, or all, of the overhead costs. The articles which face much competition can be sold at any price above their additional cost because the other articles are covering the existing overhead costs. The firm selling many products has the advantage over the competitor who sells only one product or a few products.

A manufacturer of razor blades goes into the production of a shaving cream, which he sells at a price below that of well-known brands of shaving cream. The shaving-cream manufacturer can, of course, meet this competition by going into the manufacture of razor blades, or toothpaste, or sun-tan lotion. The radio store begins to sell cameras and hardware, the drug store sells fountain pens, the cigar store sells shirts and toys and watches, and the grocery store stocks electric-light bulbs and vitamin tablets. A department store opens a shoe repair and dry-cleaning service, while a manufacturer of rayon turns out plastic products. The corner candy store has become virtually a little department store. All these businesses are diversifying their products in an effort to increase volume of sales.

## Overhead Costs and Cutthroat Competition

When times are good, this drive for greater volume may not do much harm to the competing firms. When business slows down, however, the pressure of overhead costs leads to *cutthroat competition.* Competition is considered cutthroat when businessmen sell goods "below cost." Ordinarily cutthroat competition means that the business loses money. Such is the case when severe competition forces the businessman to operate at a loss while awaiting improvement in market conditions. In other cases, however, cutthroat competition results from pricing practices. A firm is said to be selling below cost if it sells some of its goods at prices which do not cover the overhead costs, although most or all of the direct costs are covered. The firm depends on its other business to cover the overhead costs. In bad times this type of price discrimination is widespread. Big customers are given lower prices because loss of their orders to competitors would be serious. Cut prices are offered to some firms in order to get them away from competitors. Surplus stocks are *dumped,* or sold below the


*The Wallgreen Company*

The interior of this modern drug store is a fine example of diversification of product. The old-fashioned pharmacy specializing in compounding prescriptions could not compete in volume with what is virtually a miniature department store.

usual price, through outlets that do not compete with the usual outlets; that is, in a different field of business, in other parts of the country, or in foreign countries. The larger the percentage of a firm's overhead costs already covered by the volume of business on hand, the more prices can be cut for the purpose of getting additional business. And the more new business the firm gets through cut-rate methods, the more it can afford to cut prices even lower in order to get still more business.

The result may be a vicious circle. The cutting of prices forces businessmen to get more volume. In order to get more volume, businessmen have to cut prices. The resulting competition brings lower prices to consumers. Yet it may lead businessmen to put inferior merchandise on the market and to use questionable methods of getting business. The final result may be a breaking down of opportunities for profit-making in specific industries or in the business world as a whole, with bad effects on wages and employment.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| cutthroat competition | dumping |
| diversification of product | markup |

### II Questions and Problems

1) Describe various ways in which businessmen try to increase the volume of business when competition is great.
2) Explain how charging varying prices to different customers can help a business to increase its profits.
3) Show how varying of price for the same product is practiced in the following cases: (a) fees charged by doctors and lawyers; (b) rates charged by telephone, electric, and gas companies; (Note the information about variations in rates on the back of bills for electricity and in the telephone directory.) (c) railroad freight rates.
4) (a) Why may a large department store be able to undersell specialty stores carrying competing merchandise? (b) Why may a specialty store be able to undersell the large department stores?
5) American business firms spend hundreds of millions of dollars every year for industrial research. What connection is there between overhead costs and this research work?
6) Explain each of these viewpoints: (a) overhead costs are a primary cause of business failures and depressions; (b) overhead costs are a factor forcing us to make continual progress.
7) A manufacturer of an electrical appliance made by new production methods has a plant whose capacity is 100,000 appliances per year. His direct costs per unit are $5. His total overhead is $500,000 per

year. His sales have been 20,000 per year, at a selling price of $20 each. A department store chain which does not now handle his product offers to pay $9 each for 30,000 appliances to be sold under the store's own brand name. (a) Would it pay to accept at this price? (b) At what price for the additional 30,000 would the manufacturer be no better off or no worse off than if he did not accept the offer?

III THINGS TO DO

1) Pay a visit to the neighborhood stores, to nearby department stores, to the box office of your local movie, etc., and write a report on the examples you can find of price variations for the same product or service, and of diversification of product.
2) Draw a graph to represent the table of costs and profits for the years 1945–1948, as shown on page 240.

# LESSON 32 THE COST OF DISTRIBUTION

## THE GROWING COST OF DISTRIBUTION[1]

A magazine once published the following advertisement:

THERE'S SOMETHING VERY STRANGE ABOUT THIS GROCERY STORE.

Mrs. B: A dozen oranges, please.
Grocer: Oranges? We sell oranges only at Christmas time.
Mrs. B: How surprising! I'll take six cans of Blank's tomato juice.
Grocer: Tomato juice? Sorry, I never heard of that!
Mrs. B: Well then, what brands of coffee do you carry?
Grocer (puzzled): Brands? I keep coffee in bulk. I can grind you some.
Mrs. B: I can't wait. And I suppose you'll tell me you haven't even got soap flakes!
Grocer: What *are* soap flakes, anyhow?
Mr. B (angrily): Say, what sort of a store *is* this? Sugar in barrels! And only loose crackers!—Let's leave.
Mrs. B: There's something very strange about this store. Even the grocer looks like a ghost!

You can be sure this 1939 husband and wife *did* see a ghost! They've just found how strange it would be to walk into the old-time grocery their mothers and grandmothers knew.

Gone are the days of a few monotonous foods, and long hours in the

[1] The word "distribution" is not used here in the way that it was used in Unit 3. There the distribution of income among various groups in the community was discussed. In this lesson the term refers to the distribution of goods from the time they have been produced until they reach the final consumers. See the diagram on p. 248.

kitchen. . . . What caused this change? Many people, many things: . . . the grocers who fill their stores with the finest things for you . . . modern transportation—automobiles and trucks, steamships, railroads and airplanes that speed perishable foods not only 3000 miles across the continent, but from foreign lands as well.

. . . the refrigeration industry, without which many foods would spoil or lose flavor and freshness in transit, in stores, and in the home.

. . . and advertising, by which manufacturers and grocers have informed you about these new products, and have lowered prices through mass production and volume sales.

This advertisement pictures the growing importance of *distribution* in our economic life. "Distribution" as used here refers to the processes involved in getting goods from the producer to the consumer—shipping, storage, financing, and selling. The Twentieth Century Fund once published a report indicating that in the late 1930's out of every dollar spent for goods, 59 cents represented the cost of distribution, and only 41 cents went for the cost of producing the goods.[2]

The 59-cent figure was an average of distribution costs for all kinds of farm products and manufactured goods. Another name for these costs is *price spread,* because it is the difference between the retail price and the cost of producing the article. In the case of perishable fruits and vegetables, 75 to 85 percent of the price paid by the consumer was for distribution costs, and only 15 to 25 percent of the retail price represented the price the farmer received for these products. Studies of manufactured goods showed distribution costs ranging from 11 to nearly 80 percent. The importance of price spreads is illustrated in the chart on the page opposite.

These large price spreads result from the cost of middlemen's services. A *middleman* is any kind of business firm which specializes in one or more steps of the process of distributing goods and services. The diagram on page 248 shows in a simplified way the vast system of distribution—transportation, storage, banking, wholesaling, and retailing—which is required to help bring vegetable, animal, and mineral products from the producers to the consumers.

The growth of distribution services is shown by these figures: in 1870, 75 percent of all gainfully employed workers were engaged in production, and 25 percent in distribution occupations; by 1930, the percentages were 50 and 50. This point is further illustrated in the chart on page 249.

The high cost of distribution does not necessarily mean that middlemen, over the long run, are making exceptionally high profits. The problem is that the furnishing of all these services by the middlemen is

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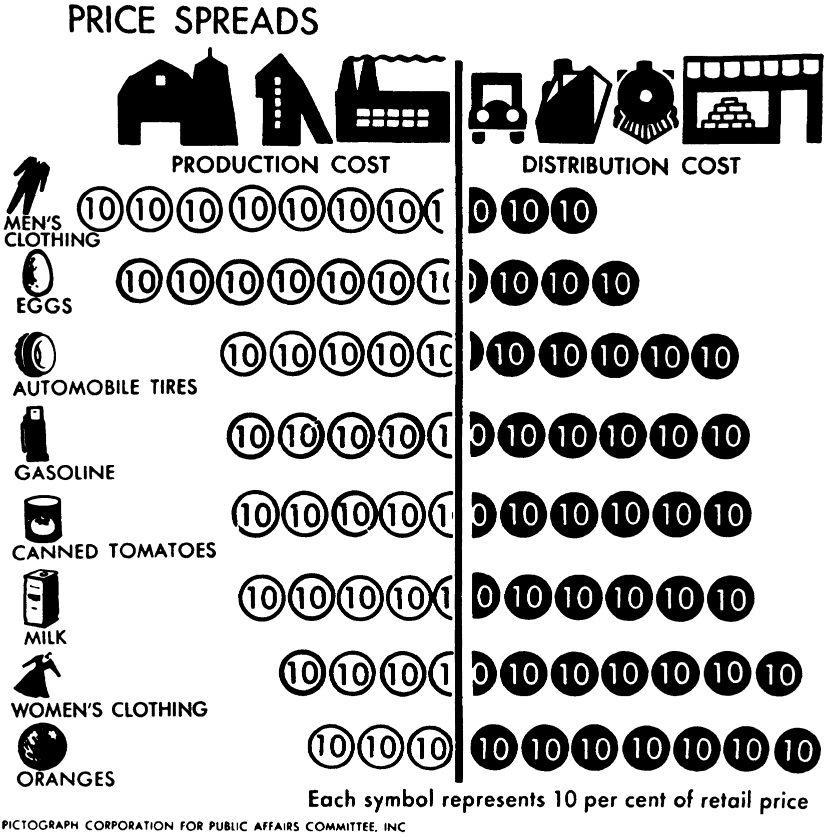
[2] *Does Distribution Cost Too Much?* Twentieth Century Fund, 1939.




The chart shows the importance of distribution costs as well as their variation in importance from product to product. These costs varied from about 25% for men's clothing, to about 70% for oranges. What are some of the causes of such variation from product to product?

expensive. The cost of distribution has become so high that much of the saving from mass production is being lost.

### Factors in the High Cost of Distribution

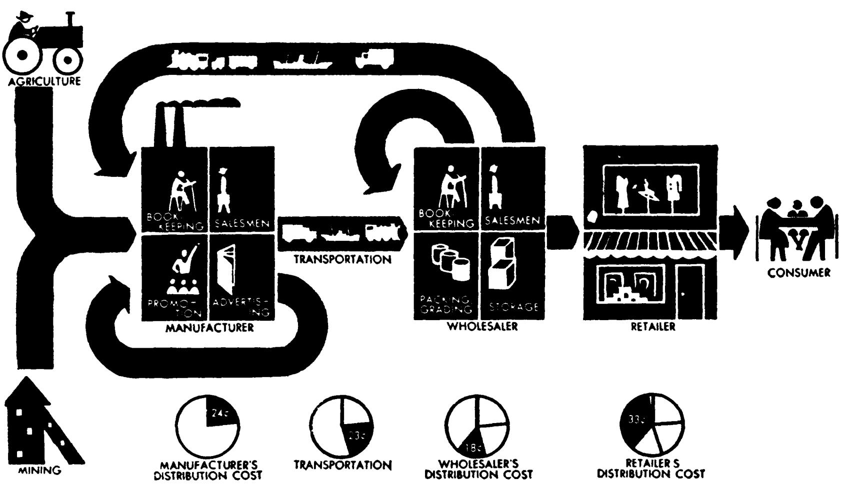
Among the many factors which have led to the high cost of distribution the following are regarded as the most important:

1. *The consumers' lack of training and their demands for special services.* We have already studied about the bewilderment the consumer faces in his buying of goods and services. Because people are so easily influenced by slogans, brand names, pseudo-scientific jargon, and glamorous endorsers, producers are encouraged to spend a great deal

on selling techniques. In addition, consumers have learned to demand all kinds of special services—and these services cost money. They give more convenience and comfort, but they also increase the middleman's cost of doing business.

2. *Wasteful methods of competition.* Mass production creates pressure on sellers, whether manufacturers, wholesalers, or retailers, to get

THE FUNCTIONS AND COSTS OF DISTRIBUTION




National advertising and other costs amount to 2¢ of the distribution dollar

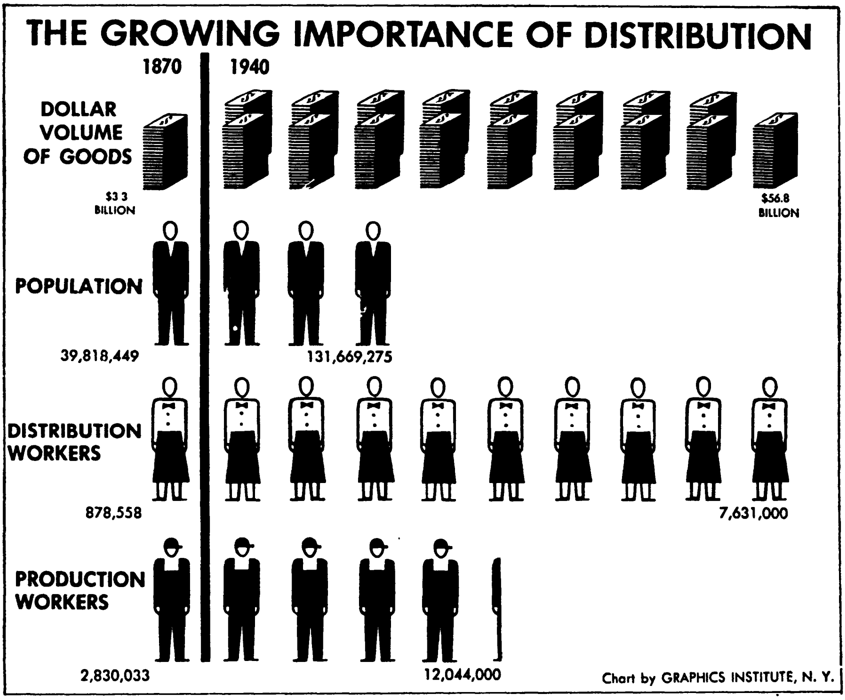
*Pictograph Corporation for Public Affairs Committee, Inc.*

**The diagram illustrates some of the services of middlemen; it also shows some of the duplication of expense as goods move from producer to consumer. Of each dollar of distribution costs, manufacturers paid 24¢, transportation 23¢, wholesalers 18¢, and retailers 33¢.**

maximum volume. A great deal of money has to be spent on the selling process. These selling expenditures are duplicated by all the competing business firms, so that the ratio of selling expense to the total volume of goods produced may become excessive. If you have ever counted the number of milkmen who supply a single apartment house every morning, or if you have ever counted the number of butcher stores, fruit and vegetable stores, and drug stores, in a well-populated neighborhood, you have observed this duplication of distribution services. To the extent that this duplication causes businessmen to give their customers lower prices and better goods, it has been a good thing. Moreover, this duplication of services reflects the American freedom of enterprise. But economists question whether, beyond a certain point, more duplication saves money for the community. Is the money spent on this addi-

tional competition greater proportionally than the reduction in retail prices which may follow?

Probably one difficulty is that many businessmen lack an accurate knowledge of business costs and therefore open up new businesses, or build up existing businesses, beyond the point where there is any gain to the community. The risks of wholesale and retail business are exceptionally high because of perishability, style changes, and the ease with




Each item in this graph is compared to what it was in 1870. Thus, while dollar volume of goods expanded to about 19 times what it was formerly, population was only 3 times as great. Distribution workers were about 9 times the number in 1870, while production workers were only 4 times the number in 1870. (Data from Public Affairs Pamphlet No. 44, "59¢ of Your $1")

which new firms may enter the field. The *mortality rate*—the percent of firms going out of business—is much greater in the fields of distribution than in production.

3. *Interstate trade barriers.* This term sounds strange to Americans, who have long prided themselves on the constitutional guarantee of freedom of interstate commerce. But recent studies have shown an alarming growth of interstate trade barriers; that is, laws and regulations established by the various states for the purpose of giving busi-

nessmen within each state an advantage over businessmen in other states. A few examples of interstate trade barriers follow.

A state once required that a harmless red dye be introduced into any milk coming from outside the state's own milk shed.

In one state the tax on wine from out-of-state grapes was at one time more than twelve times as great as the tax on wine from grapes grown within the state.

A trucking firm in 1940 had to pay $1100 in taxes to the three states through which its trucks traveled.

Some states use quarantine regulations forbidding the entry of goods which might be diseased, as a means of protecting local animal and fruit farmers against competition from the farmers of other states.

A 1939 investigation uncovered the existence of more than a thousand state laws restricting the purchase of goods and services from business firms and farmers in other states. Since these laws reduce competition, their effect is to increase the cost of goods and services to consumers.

4. *Fair-trade laws* and *chain-store taxes.* Practically every state in the Union has adopted fair-trade laws. These laws allow producers of brand-name goods to fix the retail prices of these goods; the retailers are forbidden to cut the prices set by the producers. This practice by producers of setting retail prices is called *resale-price maintenance.* In 1937 the federal government passed the Miller-Tydings Act to allow resale price maintenance in interstate commerce. In addition, about twenty states have laws placing special taxes on chain stores. The purpose of both these types of laws is to give small, independent businesses a better chance to compete with chain stores and large department stores. As a result of these laws, however, the consumer may pay higher prices for goods. The assumption is that the consumer will nevertheless gain if small business firms are helped to survive and competition is preserved.

### Reducing the Cost of Distribution

The remedies for the entire problem are suggested by the difficulties outlined. Better-trained consumers might coöperate with producers and middlemen to reduce the costs of distribution. The work being done by consumer testing agencies, public agencies, and consumers' coöperatives will help to train consumers to get more for their money. At the same time, businessmen, through further studies of distribution costs, may learn to operate more efficiently, and pass the savings along to consumers. In agricultural production this is already being done to a large extent by farmers' coöperatives. Similar work is being done in industrial and distribution fields by trade associations. The states have been urged to coöperate in overhauling the many hundreds of state laws which in-

terfere with interstate trade. They have been asked to make a distinction between laws which genuinely protect the health and welfare of the people in a state, and those which tend mainly to protect special interests within the state.

### Exercises and Activities

I Dictionary of Economic Terms

| | |
|---|---|
| distribution | mortality rate |
| fair-trade law | price spread |
| interstate trade barriers | resale-price maintenance |

II Questions and Problems

1) Summarize the various reasons for the high cost of distribution.
2) How do you explain the differences in price spreads shown in the chart on page 247?
3) What significance may the figures in the chart on page 249 have for high school students planning their careers?
4) "There are too many middlemen." "Middlemen can be eliminated, but not their functions." Explain and discuss these statements.
5) The Twentieth Century Fund report on distribution said that independent merchants were holding their own against the chain stores, large department stores, and mail-order firms. Is this a good or bad thing for the community? Why?
6) Outline several ways in which the cost of distribution might be reduced by (a) consumers' actions; (b) actions of national, state, and local governments; (c) manufacturers; (d) wholesalers and retailers.
7) Summarize the arguments for and against fair-trade laws or chain-store taxes.

III Things To Do

1) Make an analysis of your neighborhood, to get evidence as to whether there is excessive duplication of retail services.
2) Read and summarize Public Affairs Pamphlet No. 44, *59¢ of your Dollar—The Cost of Distribution* (Public Affairs Committee, 1940).
3) Find out whether your state has a fair-trade law or a special tax on chain stores. If yes, what are the provisions of the laws?
4) Coöperate with other members of your class in getting the opinions, orally or by letter, of independent storekeepers, managers of department stores and chain stores, and consumers, in your community, about the desirability of fair-trade laws. Summarize these opinions in a report.
5) Write a report on how the use of middlemen is lessened by the use of (a) farm coöperatives, (b) consumer coöperatives, (c) mail-order houses.

# LESSON 33 THE MARKET: SUPPLY, DEMAND, AND PRICE

## Economic Value

In the first lesson in this book, you learned that our economic system is based on the buying and selling of goods which have economic value. Economic value expressed in terms of money is a *price:* the amount of money which will be given in exchange for a good or service.

The first basis of economic value is *utility,* or usefulness—the ability of goods and services to satisfy our wants for food, clothing, shelter, recreation, education, and security, and other things. Wants or desires do not, however, have any effect on prices unless they are combined with ability to pay. Many would like to own a luxurious yacht; but the price of yachts is not affected by the wants of those who have not enough money to buy yachts.

The second basis of economic value is *economic scarcity,* which means that the amount available is smaller than the amount which people would like to have. Diamonds are much less useful to us than air; but diamonds have economic value, whereas air does not. The reason is that the number of diamonds is small compared with the number which people would like to have, whereas ordinarily there is more than enough air for everybody.

When goods are scarce, they have a cost because labor, capital, and other factors of production must be spent to get them. This cost is important in determining price.

Because goods have economic value, buyers and sellers come to the market to engage in competition and bargaining. *Competition* is the rivalry which occurs on each side of the market: buyers compete with one another for the goods and services which are available, and sellers compete with one another for the business of the buyers. *Bargaining* is the process whereby buyers and sellers try to get the best possible prices from each other. Every seller tries to get from the buyers the price which he thinks will give him the most profit. Each buyer tries to persuade the sellers to give him the lowest possible prices. All buyers and sellers must adapt themselves to the conditions in the market.

## Overlapping and Insulated Markets

A *market* is a coming together of buyers and sellers. "Coming together" does not mean that the buyers and sellers actually face one another; they may be far apart, and yet be in the same market. A farmer raises chickens and eggs, and sells them to his neighbors; the farmer and his customers constitute a small, but complete, market. A typical

dairy farmer is part of a much larger market, consisting of thousands of dairy farmers and all the dairy companies in that section of the country. For some goods, such as wheat and rubber, the market consists of buyers and sellers in all parts of the world.

Often one market is part of another. The neighborhood dress shop and the women who patronize it constitute a market. But the amount of business which the owner of the dress shop will get from these women and the prices he will charge them are influenced by what is being offered in the downtown stores. The neighborhood stores and the downtown stores are, therefore, to some extent part of the same market. Because of the development of the automobile, small-town merchants find that their market is overlapped by the markets of the larger cities nearby. They also have to meet the competition of mail-order houses hundreds of miles away. A market may be even broader; for example, the jewelry stores and their customers form a complete market; but they are also part of the retail market as a whole, in which other goods and services are competing with jewelry for the customers' money.

We may say that the whole world is a single market, in which all goods offered for sale compete with one another. The traders in the wheat market in Chicago watch the prices of wheat in Kansas City, Winnipeg, and Liverpool. American watch manufacturers have to worry about the prices of Swiss watches. Synthetic rubber produced in the United States competes with natural rubber from the Far East. Bread, potatoes, and spaghetti are rivals for the consumer's dollar; so are canned goods, frozen foods, and fresh fruits and vegetables; also the motion-picture theater, the ball game, and the bowling alley. Every seller of an article feels, directly or indirectly, the competition of all other sellers of the same article in various parts of the world. In addition, he faces the competition of every article which might be substituted for his. Thus the economic world consists of a countless number of *overlapping markets.* Markets overlap with one another to the extent that the actions of buyers and sellers in one market are affected by the actions of buyers and sellers in other markets dealing with the same or substitute goods and services.

Despite this universal overlapping of markets, there exists a remarkable *insulation of markets.* A market is insulated to the extent that the buyers and sellers in that market are partly or completely unaffected by developments in other markets handling the same articles or substitutes. Two grocery stores may do business side by side for many years. One store attracts its customers by charging low prices on a cash-and-carry basis. The other store charges higher prices, but gets its customers by giving telephone and delivery service, extending credit, and in other

special ways catering to the customers. Each of these stores and its customers is a market, almost entirely insulated from the market functioning next door to it. Neighborhood stores may find it hard to match the bargains of some downtown department stores, but they secure the business of people who haven't the time or inclination to go downtown. The manufacturers of well-known brands of canned goods, drugs, and cosmetics can charge higher prices than their competitors, and still get business, because the people who have faith in these brand names will not buy other brands even at lower prices. Location, special services, brand names, slogans like "Buy American" or "Patronize your neighborhood druggist," fair-trade laws, interstate-trade barriers—all these are factors which help to insulate one market from another, and thereby lessen the amount of competition.

In actual practice, all markets are a mixture of overlapping and insulating factors. If the overlapping factors are stronger than the insulating factors, the market is highly competitive. If the insulating factors are stronger than the overlapping factors, the market has less competition; such a situation has *monopolistic* elements. This problem of competition and monopoly will be further analyzed in later lessons.

### The Factors Which Affect Supply

In a system of free competition, prices are determined fundamentally by two factors, *supply* and *demand.*

"Supply" means the amount which sellers are willing and able to sell at a given time at a given price. Each seller decides how much he would like to sell, and what price he would like to get, on the basis of his costs, in order to receive the amount of profit for which he is aiming. He has to take various factors into consideration. How many other sellers of the same product are in the market, and what prices are they asking? How much more of the product would be brought into the market if prices should be high enough to make the business very profitable? To what extent would a high price cause buyers to shift to substitute articles? What has been the usual price for the article? Are times so good that raising the price will cause little protest from buyers, or so bad that it will be hard to sell the goods at previous prices? On the basis of such considerations, every seller decides how much to supply and what price he will ask.

One major factor which influences the seller's decision about the price he will ask is the elasticity of supply. A supply is *elastic* if it varies greatly as a result of proportionately small changes in price. Thus, the supply of men's hats can normally be stepped up or down quickly as the price changes. A supply is *inelastic* if it varies very little as a result of proportionately small changes in price. After planting, the supply of

strawberries cannot be changed much. This same inelasticity is true, in general, for agricultural products. In no case is supply completely inelastic. It is impossible to produce any more paintings by the great masters of bygone times, or any more genuine Stradivarius violins; but if the prices offered for those articles should rise sufficiently, more of the people who own these rare items would be willing to sell them. When atomic energy was developed, new supplies of the scarce minerals needed for atomic energy were discovered in various parts of the world. We do, however, apply the term "inelastic" to the supplies of these articles, because it is relatively difficult to increase these supplies, or because additional supplies are withheld from the market by monopolistic control unless the price goes up very high.

### The Factors Which Influence Demand

Demand means the amount which buyers are willing and able to buy at a given time at a given price. How much they will buy, and what prices they will be willing to pay, depend on a number of factors. When the buyer is a businessman, one of the most important factors is the price he expects to get from his own customers. Thus, the price which the automobile manufacturer will be willing to pay for sheet steel is influenced considerably by the price at which automobiles are being sold. Another factor is general economic conditions. In good times buyers will pay higher prices if asked by the sellers, whereas in bad times the buyers will hold back, hoping that prices will come down. Buyers try to judge the supply situation. If a large supply is "visible"—coming into the market—, or if substitute articles are available, they will offer lower prices; if the supply looks small, and substitutes are not available, they will have to offer higher prices. The number of buyers is another factor. If there are many buyers seeking merchandise, they may bid against each other, and the prices will be higher. If buyers are few, it will be easier for them to get merchandise at lower prices.

The elasticity of demand varies from one good or service to another. The demand is elastic if it varies greatly as a result of proportionately small changes in the price; it is inelastic if it varies little as a result of proportionately small changes in price. Bread is an example of an article for which the demand is inelastic, because only a drastic change in price would cause people to change their bread-eating habits. But when the price of automobiles was raised about $100 in 1935, sales declined rapidly. Generally the demand for necessities is less elastic than the demand for luxuries.

Elasticity of demand is very important to the businessman. The more elastic the demand for an article, the greater the advantage to the busi-

nessman in cutting prices; because then a drop in price may cause the volume of sales to increase sufficiently to increase the total profit.

THE RELATIONSHIP OF SUPPLY, DEMAND, AND PRICE

The relationships of supply, demand, and price are summarized in the following chart.

**THE INTERRELATIONSHIPS OF SUPPLY, DEMAND, AND PRICE**

| IF | WHILE | THEN | Relationship |
|---|---|---|---|
| D ↗ | ← S → | P ↗ | Direct |
| D ↘ | ← S → | P ↘ | Direct |
| S ↗ | ← D → | P ↘ | Inverse |
| S ↘ | ← D → | P ↗ | Inverse |
| P ↗ | ← Income and Spending Habits → | D ↘ and/or S ↗ | D inverse<br>S direct |
| P ↘ | ← Income and Spending Habits → | D ↗ and/or S ↘ | D inverse<br>S direct |

**D stands for *Demand,* S for *Supply,* and P for *Price.* The line and arrow show direction of change. Thus, reading across the first line, if demand rises while supply does not change, price will rise. This is a *direct* relationship between demand and price.**

There are several important points to notice. First, when demand changes, price changes directly; that is, in the same direction. When supply changes, price changes inversely; that is, in the opposite direction. When price changes, demand reacts inversely, while supply reacts directly.

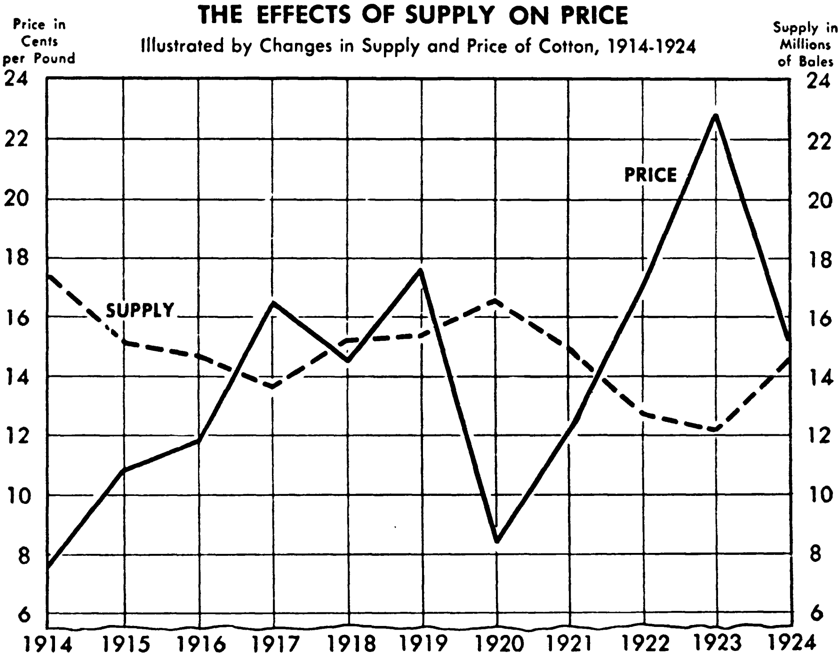
Second, supply and demand do not affect each other directly, but only through actual or anticipated changes in price. If demand increases, it pushes up the price; the rise of price stimulates an increase of supply. If supply declines, price moves upward, thereby limiting demand. Thus, price, by moving upward and downward, tends to change supply and demand in such a way as to keep them in balance.

Third, all these reactions of supply, demand, and price to one another depend on "other things being equal." This phrase refers to the "While" column in the chart on this page. An increase in the supply of fish should cause a drop of price; but it will not, if the demand for fish

is unusually high as a result of high meat prices. At the end of the summer the demand for golf balls drops, and the price should drop, too. If, however, there is a shortage of golf balls because of scarcity of rubber, the storekeepers will not lower the price. "Other things being equal" means, then, that a change in demand (or supply) will affect price in a certain way, provided there is no offsetting change in supply (or demand).

**THE EFFECTS OF SUPPLY ON PRICE**

Illustrated by Changes in Supply and Price of Cotton, 1914-1924




Note that in every year except 1919, a rise in the supply (dotted line) was accompanied by a decline in the price (solid line), and a fall in supply was accompanied by a rise in the price. (Prices have been adjusted for changes in the general price level.) (Data from U.S. Dept. of Agriculture)

A factor which prevents "other things from being equal" is that people sometimes anticipate changes in price and therefore do the opposite of what the chart on page 256 shows. A rise of cattle prices may not speed up the supply of cattle to the market; instead, the farmers may decide to wait until prices go up still more. For a while, at least, the rise of price may cause a shrinkage of supply. When, in 1939, the price of sugar jumped, it did not check the demand for sugar; people rushed to buy sugar before the price went up further. Likewise, when prices of goods begin to move downward, there is a tendency for some buyers to hold off buying until prices come down still more, while some sellers rush to

sell before the price goes down further. Such actions interfere with the tendency of changes in price to bring about a balance of supply and demand.

One of the most important factors influencing demand is the amount of income which people are receiving. When times are good, a rise of price for a particular article may not cause a drop in demand, if many people have enough money with which to buy at the higher price. As incomes rise, demand becomes more inelastic; some things formerly regarded as comforts are now considered necessities. In a depression period, lowering the price may not stimulate demand, if people lack the necessary income with which to buy even at low prices. During the 1940's there was a *sellers' market*—shortages of goods and abnormally large demand. Buyers had to, and were able to, pay high prices. Before that, in the 1930's, there had been a *buyers' market*—large supplies and low incomes. Sellers had difficulty in disposing of goods even at low prices. Expansion and contraction of income, with the resulting changes in spending habits, are an important interference with "other things being equal."

Each of the many thousands of prices in the business world is the result of all the factors which we have discussed in this lesson. Since these factors cannot be measured precisely, there is no mathematical formula by which the buyers and sellers can determine the "right" price. In practice each price is an experiment, based on the judgments of sellers and buyers. Prices are constantly being adjusted on the basis of the experiences of sellers and buyers. The businessman, over a long period of time, must sell his goods or services for enough to cover his total costs. He may, for a short period, sell for less than cost; or he may, for a long period, sell some of his goods below cost. However, in the long run, total income must be greater than total cost if there is to be a profit.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| bargaining | elastic supply | overlapping markets |
| buyers' market | inelastic demand | price |
| competition | inelastic supply | sellers' market |
| demand | insulated markets | supply |
| economic scarcity | market | utility |
| elastic demand | | |

### II Questions and Problems

1) Explain what is meant by the statement, "Prices are determined by the law of supply and demand."

2) (a) State and explain two factors affecting the supply of any product you choose. (b) State and explain two factors affecting its demand.
3) What is the difference between utility and economic value?
4) Explain the degree of elasticity of supply for each of the following items: shoes, steel, wheat, inexpensive jewelry, diamonds, antique furniture.
5) Explain the degree of elasticity of demand for each of the following items: milk, strawberries, dresses, school supplies, refrigerators.
6) Describe the market for each of the following, discussing (a) the numbers and kinds of buyers and sellers, and (b) the amount of overlapping or insulation: oranges, peanut butter, steel, velvet fabrics.
7) Describe the effects of each item in the first list on the supply or demand, and on the price of the corresponding good or service in the second list:

| INCIDENT | GOOD OR SERVICE |
|---|---|
| (a) heavy damage by boll weevil | (a) cotton |
| (b) good potato crop | (b) potatoes |
| (c) new long skirts style | (c) textiles |
| (d) development of rayon | (d) silk |
| (e) rise of national income | (e) television sets |
| (f) Thanksgiving Day | (f) turkeys |
| (g) Tennessee Valley Authority | (g) electricity |
| (h) rise in price of tin | (h) canned foods |
| (i) drought which forces farmers to rush animals to market | (i) meat |
| (j) introduction of mass-production methods | (j) airplanes |
| (k) perfection of alcohol fuel for automobile engines | (k) gasoline, grains |
| (l) higher wages in Europe | (l) American automobiles |
| (m) housing program in Great Britain | (m) American cement |

8) Explain how the amount of competition depends on the extent to which a market is insulated or overlapping.
9) (a) Explain what is meant by acting in anticipation of price changes. (b) Show how buyers and sellers may, by anticipating price changes, sometimes work against their own interests.
10) (a) Select an item which you consider to be high-priced at the present time, and list the factors which you think may be responsible for the high price. (b) Select an item which you consider to be low-priced at the present time, and list the factors which you think may be responsible for the low price.

## III THINGS TO DO

1) Make a simple diagram of the shopping area of your neighborhood, illustrating the overlapping and insulation of markets.

2) Over a period of two months keep a record of the prices of ten articles sold in different types of stores in your neighborhood. At the end of the project try to explain the reasons for the differences in the price fluctuations, or absence of price changes, of the various items.
3) Make a comparison of the prices of some branded items in different stores. What differences in prices for identical items do you find?

# LESSON 34 PRICING IN AN ORGANIZED MARKET

## THE ORGANIZED MARKET

Walking into the New York Cotton Exchange, on the 19th floor of a skyscraper in the Wall Street district, is a novel experience. In the center of the large hall is a circular railing, about three feet off the ground and about twelve feet in diameter. Around this ring stand from forty to fifty men of all ages, shapes, and sizes. The noise at first is deafening, for the traders surrounding the ring seem to be acting like a bunch of boys who have just been let out of school. But these are serious businessmen, negotiating "contracts" for the purchase and sale of bales of cotton.

Obviously, this is not the way buying and selling are done in most parts of the business world. The cotton exchange is an *organized market*[1]; that is, trading on this exchange can be done only by those who are members of the exchange, and trading must be done in a set place, during stated hours, and according to strict rules. There are three essential differences between trading on an organized exchange and ordinary buying and selling.

First, the organized markets deal in standardized contracts. Cotton brokers, for example, deal in cotton of a stipulated quality, which has been inspected and certified by experts employed by the Cotton Exchange and by the government. The cotton is kept in bonded warehouses in bales of 500 pounds each. The trading unit is 100 bales. Wheat, cocoa, eggs, rubber, hides, and the many other commodities which are traded on organized exchanges are likewise inspected and graded and sold in standard units. The buyer on an organized market knows exactly what he is buying. He is guaranteed by the rules of the exchange, and by possible penalties for the seller, against any error or misrepresentation regarding quantity or quality of what he is buying.

Second, on an organized market every trader has full information

[1] There are two major types of organized markets: *commodity exchanges*, as described in this lesson, and *securities exchanges*, as described in pages 182–184.

about all bids, offers, and sales. Buyers may make their bids, and sellers their offers, only at the trading ring and only by "open outcry"; so that every trader knows the supply-and-demand situation from minute to minute. With the aid of the blackboards, tickers, and other sources of information, the cotton trader in the New York Cotton Exchange knows what is happening to the price of cotton not only in New York, but also in New Orleans, São Paulo, London, and all other organized cotton markets. In addition, there are bulletin boards giving the traders up-to-

*New York Cotton Exchange,* Daily News *photo*

**Traders call and signal around the trading ring of the New York Cotton Exchange. Only members have the privilege of buying or selling; outsiders must use the services of brokers who are members.**

date crop forecasts, production figures, weather reports, and other information which will help them predict the supply-demand-price trends for the next day, the next month, and the next year.

Third, at any given time, there is only one price for a commodity traded on an organized market. Since trading is done openly, and all sales are immediately and publicly recorded, it is hardly possible for more than one price to prevail at any moment. No buyer is going to

bid 34½ cents when sellers are offering cotton for 34 cents; nor will any seller offer cotton at 34 if some buyer is bidding 34½. Only when all cotton offered at 34 cents has been bought up, will any buyer bid 34½; and only when no buyer will take any more cotton at 34½, does the seller come down to 34.

Although there is only one price at a time, during the day there may be a considerable number of changes in the price of a particular commodity in an organized market. Frequent, fractional changes in prices result from the quick reactions of interested manufacturers, merchants, and speculators to the slightest changes in the supply-demand-price situation.

These three elements—standardized commodities, open trading, and a single price—are to be found in all the organized markets. These elements are the result of the strict rules which each exchange has established regarding the procedures for buying and selling. Through the tickers and newspapers the entire world is able to watch the process of price making as it goes on from hour to hour and day to day in the stock exchanges of New York, London, Paris, and many other cities; in the "wheat pit" of the Chicago Board of Trade; in the stockyards of Chicago and Kansas City; in the mining-stocks exchange of Toronto; and in every other organized market throughout the world. The newspaper excerpt below illustrates the daily newspaper reports about price quotations in the commodity exchanges.

| | Open. | High. | Low. | Close. | Prev. Close. | Last Year. |
|---|---|---|---|---|---|---|
| **WHEAT** | | | | | | |
| May | 2.23⅝ | 2.24 | 2.23 | 2.23¼ | 2.23½ | 2.14⅛ |
| July | 2.00 | 2.00⅜ | 1.99⅝ | 2.00 | 1.99⅝ | 1.90⅞ |
| Sept. | 2.00¼ | 2.00⅞ | 2.00⅛ | 2.00½ | 2.00¼ | 1.90⅜ |
| Dec. | 2.03¼ | 2.03⅝ | 2.02¾ | 2.03⅜ | 2.02⅞ | 1.90⅞ |
| **CORN** | | | | | | |
| May | 1.34 | 1.34⅛ | 1.33⅜ | 1.33⅝ | 1.33⅞ | 1.31⅝ |
| July | 1.34¼ | 1.34¼ | 1.33⅝ | 1.33¾ | 1.33⅞ | 1.31⅛ |
| Sept. | 1.30⅛ | 1.30½ | 1.29⅞ | 1.30½ | 1.30⅛ | 1.24¾ |
| Dec. | 1.22¼ | 1.22⅝ | 1.22 | 1.22⅜ | 1.22¼ | 1.13⅝ |
| **OATS** | | | | | | |
| May | .73½ | .73¾ | .73¼ | .73⅜ | .73½ | .68⅜ |
| July | .64⅞ | .65 | .64⅝ | .64¾ | .64¾ | .62⅞ |
| Sept. | .64 | .64 | .63⅝ | .63⅞ | .63¾ | .62¼ |
| Dec. | .. | .. | .. | .65⅜ | .65⅜ | .63⅝ |
| **RYE** | | | | | | |
| May | 1.30½ | 1.31¼ | 1.30¼ | 1.31¼ | 1.30½ | 1.26¾ |
| July | 1.33 | 1.33¾ | 1.32¾ | 1.33¼ | 1.33 | 1.26½ |
| Sept. | 1.35¾ | 1.36 | 1.35 | 1.36 | 1.35 | .. |

**The "months" represent the months in which the commodity must be delivered by the seller to the buyer. Much commodity trading is in *futures,* that is, standardized contracts for delivery at a future date. The prices quoted above are per bushel. For the meaning of the various columns, compare with the stock and bond quotations on page 189.**

### Organized Markets and Perfect Competition

We sometimes talk of the *perfect market,* by which we mean a market in which there is *perfect competition.* What is meant by perfect competition is best illustrated by the organized commodities markets. There must be large numbers of buyers and sellers, no one of whom is important enough to make any significant difference in the supply and demand. All buyers and sellers must operate on equal terms, having full and equal knowledge about supply and demand factors. The article must be standardized according to known grades, so that it makes no difference to the buyer from which seller he gets the article. There must be a *free market,* without any restrictions on supply, demand, or price by government regulation or monopolistic situations.

Even in the organized markets we do not have perfect competition. Buyers and sellers are not perfectly equal in their knowledge of supply and demand conditions. There are government restrictions on price fluctuations under certain circumstances. Yet there is a close resemblance to the perfect market.

Outside of the organized markets, buying and selling are not done in this fashion. In retail stores, products, instead of being standardized, are differentiated by brand names, fancy packaging, and sales talk. The price of an article may vary from one store to another. Even in dealings between one businessman and another, buying and selling are often done unscientifically. Many decisions regarding purchases and sales of goods and services are based on personal prejudices, good or bad salesmanship, and sometimes misrepresentation. Since the deals are made in private offices rather than around a trading ring, businessmen have to guess the prices which their competitors are paying and receiving.

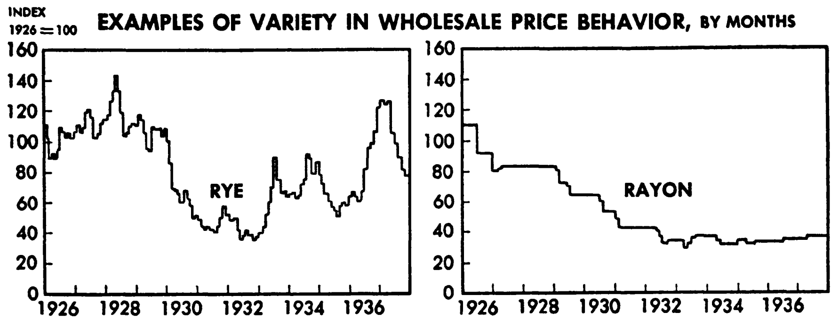
### Advantages and Disadvantages of the Organized Market

The organized markets present the clearest examples of how the laws of supply and demand operate when other things are equal. Here can be seen openly the competition among sellers and among buyers, and the bargaining between buyers and sellers. There are many buyers and many sellers, so that it is difficult for one person or group to dominate the market and establish the price.

Price on the organized market acts like the needle of a delicate meter. When the pressures from the supply side and the demand side are equal, the needle stands still; as soon as the pressure from one side is greater, the needle oscillates accordingly. If the price moves up, because of pressure from the demand side, this will normally cause more offers to appear from the supply side. Supply and demand will again become balanced, and the price for the moment becomes fixed at a definite point. If the price moves down, because of pressure from

the supply side, more bids will normally appear from the demand side. The price will again settle at a point which balances supply and demand. The sensitiveness of price in the organized market is illustrated in the following chart.

A sensitive price mechanism is of significance to producers of agricultural and mineral products, to the businessmen who buy and sell these products, and to the manufacturing firms which convert these products into finished goods. Small changes in the prices of raw ma-




A glance will reveal that rye, an agricultural product sold in a competitive market, fluctuated more frequently in price than did rayon, a manufactured product. Despite the fact that rayon dropped considerably, price changes tended to be less frequent. (Data from *Structure of the American Economy*, Part I, National Resources Committee, June, 1939)

terials can make large differences in the profits of businessmen. The existence of an organized market enables them to buy and sell futures contracts at any time that may fit their needs. In this way they reduce their risks and stabilize their profits.[2]

The very fact that prices on the commodity exchanges are so sensitive creates opportunities for speculators. Normally, the daily buying and selling by speculators helps to stabilize the prices of the commodities traded on the exchange, so that the risks are limited for both buyers and sellers. On the other hand, speculation sometimes tends to accentuate the upward and downward movements of prices, as the speculators rush to buy and sell in anticipation of price changes.

Actually, only a small part of the supplies of the various commodities is sold on exchanges. The major part moves from producers to middlemen and manufacturers. The prices paid in these private transactions are influenced to a considerable extent, however, by the prices set on the exchanges.

[2] Buying and selling of futures contracts for the purpose of reducing risks is called "hedging." A detailed description of hedging can be found in advanced economics textbooks.

Whenever there is speculation, there is the danger that some speculators will try to manipulate the market for their own profit. Because such manipulation has occurred, Congress passed the Grain Futures Act of 1922 and the Commodity Exchange Act of 1936. These laws regulate the activities of commodity traders, limit the daily movements of prices on the commodity exchanges, and forbid manipulation.

### Exercises and Activities

I Dictionary of Economic Terms

free market
organized market
commodity exchange
perfect competition
perfect market

II Questions and Problems

1) Describe three important differences between buying and selling on an organized market, and buying and selling of goods in the business world in general.
2) (a) Explain what is meant by "perfect market" and "perfect competition." (b) Outline some of the factors which make competition imperfect in the buying and selling of most goods and services.
3) Is the sensitiveness of prices on organized markets a good or a bad thing for the community? Explain your answer.
4) (a) Which is more characteristic of the American business world, buying by "price tag" or buying by "open outcry"? Give examples. (b) How does an auction differ from trading on an organized exchange?
5) During the latter part of the 1940's the commodity markets were blamed by some people for the high prices of wheat, corn, metals, and other goods. (a) How may speculation on the exchanges have been partly responsible for the rise of prices? (b) What answers could the officials of the exchanges give to the charges made against the exchanges?

III Things To Do

1) Let the class divide itself into several groups, so that each group can for one week follow the prices on a particular exchange. The reports on the happenings in the exchanges can be found on the financial pages of the daily newspapers. Each group should report to the class on the movements of prices, and on the factors which influenced the price movements observed.
2 At the library, or from local brokerage offices, or by writing to the exchanges (New York Stock Exchange, Chicago Board of Trade, Chicago Mercantile Exchange, etc.), get copies of literature describing the operations of the securities and commodity exchanges. Read and summarize these pamphlets.

# LESSON 35 PRICE AND EQUILIBRIUM

THE FREE MARKET AND EQUILIBRIUM

*Economic equilibrium* is like the sea level—an imaginary but important idea. When we look at the ocean, we cannot see the sea level, only the ebb and flow of the tide, and the rise and fall of the waves. Sea level is a mathematical average between high tide and low tide. In economics, too, there is never any real equilibrium, for supply and demand never stand still. "Equilibrium" means that the supply of, and demand for, an article are in approximate balance. The best evidence of such balance exists when the price of an article remains stable over a long period of time, perhaps a few months, sometimes for a few years. Such periods of equilibrium are hard to find in the economic system as a whole, with its changes from periods of rising prices to periods of falling prices. In some industries there is a tendency toward equilibrium.

The *free market* is regarded as one of the most important features of the capitalistic system. The free market means that buyers are free to offer whatever prices they wish, and to buy as much or as little as they wish; sellers are free to ask whatever prices they wish, and to offer goods for sale, or hold them off the market, according to their individual interests. We depend on this free market to keep our economic system in balance, through the automatic operation of the laws of supply and demand, without interference or aid from any outside source.

During World War I, and again during World War II, the demand for tin rose much faster than the supply. The price became very high, and the sale of tin was unusually profitable. Businessmen therefore opened plants for the purpose of getting scrap tin out of used tin cans and other such waste materials. At the same time many plants which had used tin for industrial purposes learned to use substitute materials. Supply was increased, demand was limited, and a balance between supply and demand was established. After the war, the demand for tin shrank to a normal level, and there was a surplus of the metal. The price went down; it was harder to make a profit. The emergency detinning plants soon closed, and the supply was reduced. The lower price induced firms which were using substitutes to return to the use of tin. The reduction of supply and the increase in demand again brought about an equilibrium.

About the end of every November, empty stores in the downtown sections of large cities are rented for the sale of Christmas cards. The demand for these cards is much greater than the supply available in the regular stationery stores, and the cards can be sold at profitable

prices. After the holiday season, when the value of the cards is practically zero, the stores become empty again.

The balance between supply and demand is achieved through the actions of *marginal enterprises;* that is, businesses which operate on a high-cost basis, or on the margin of profitableness. In almost every field, these marginal firms appear during periods of large demand, high prices, and abnormal profits; and they vanish when demand, prices, and profits drop to a normal or subnormal level. The detinning plants were built during a period of high cost of construction and machinery, and used an expensive method of producing tin; they could be run profitably only as long as the price of tin remained high. In the mining industries costs of operation vary greatly from mine to mine; the high-cost mines operate when business is good and prices are high, but shut down when demand and price drop.

The additional, or *marginal* supply, which appears when demand and price are high, comes not only from new firms entering the field, but also from increased production by firms already in the field. This increased production is likely to cost more per unit, because it comes at a time when materials, equipment, and labor cost more.

### The Flow of the Factors of Production

The balancing effect of price also helps to distribute the factors of production wherever they can be used most profitably. When building materials were in short supply, after World War II, builders of business structures were able to get such materials more easily than builders of houses. There was more profit in building business structures, and the builders could therefore outbid housing contractors for whatever materials were available. In the early 1940's, shipyards, aviation plants, and other industries in the Pacific Coast region expanded tremendously but lacked workers. By offering very high wages, the Pacific Coast industries persuaded hundreds of thousands of workers to migrate there from the East and South. Similarly, when business firms in those faraway countries want American investors to buy their securities, they have to offer higher rates of return than are offered by American firms. Business risks in Latin America and Asia are greater than in the United States. High rates of interest and opportunities for large profits have, however, caused a flow of capital to parts of the world which otherwise would be unable to get capital funds.

As the supplies of each of the factors of production increase in areas of scarcity, a balance is established between supply and demand. The price or rate offered drops to a level nearer to that of other areas. A tendency toward equilibrium is thus brought about by the automatic fluctuations of prices in a free market, and the flow of factors of production.

### The Limitations of Price as a Balancing Mechanism

The fluctuations of price do not always bring supply and demand into balance. This balance is relatively easy to achieve in a period of expansion, when the tendency is toward a heavy demand for goods, labor, capital, space, and business management. The rise of prices, wages, interest rates, rents, and profits encourages the community to produce the desired goods and services.

*Standard Oil Co. (N.J.), photo by C. Brooks*

**These cattle trucks, shown gathered in a rural market in New York State, move animals regularly to city markets and slaughter houses. Such markets and activities are the framework of the supply and demand which constantly affect the prices for farm staples.**

The failure of the price mechanism—the free market—to function effectively has been most conspicuous in times of large surpluses. When the wheat surplus forced prices down during the 1920's to a low point of forty cents a bushel in 1932, the solution appeared to be that farmers should produce less wheat. Yet the production of wheat increased from year to year. During the 1930's, coal became a surplus commodity in the United States and Europe, because of the increasing use of fuel oil and natural gas and because of increased efficiency in the use of coal.

Coal miners' earnings dropped to a low level, as few of them worked more than two or three days a week. The miners were urged to shift into other kinds of work, but few of them changed their occupation.

In modern industry, a drop of price does not necessarily cause a contraction of supply; on the contrary, it may bring an expansion. We have already seen, in studying overhead costs, that a drop of prices may force a businessman to seek greater volume in order to cover his overhead cost. The search for volume, in turn, increases the surplus of goods, and puts additional downward pressure on the price of the article. Eventually this situation may develop into a downward spiral of prices and profits. This interference of overhead costs with the balancing of supply and demand has become characteristic of our economic system—in farming, mining, manufacturing, transportation, and selling.

This situation is aggravated by the *immobility of capital,* that is, the difficulty of transferring funds from one enterprise or industry to another. When a business is losing money, it may still continue to operate —sometimes for many years. If it closes down temporarily in the hope of opening again when conditions improve, rent or taxes still have to be paid, also debts and maintenance costs. It would be difficult to shift the plant into another line of business, because modern factories and machinery are often so highly specialized that they cannot easily be adapted for other uses. Moreover, a businessman who has spent many years in a particular kind of business finds it hard to go into another field. Shifting into a new business often involves investment of additional capital and substantial risk. Even when the conditions in an industry force some firms to sell out or to go into bankruptcy, the surplus does not disappear. The bankrupt establishments are sold at bargain prices to new owners who can operate the establishments with a lower overhead cost than the previous owners. The supply is therefore as great as before, and the competition is even worse.

During the 1930's the failure of the free market to establish equilibrium caused the government to experiment with projects for limiting production and stimulation of demand. The coming of World War II changed surpluses into shortages, however, and enabled us to forget, for a decade, about the problem of surpluses.

When a period of extreme shortages developed in the 1940's, the free market system again proved inadequate. The free market made possible speculation and hoarding, so that shortages were aggravated, and equilibrium was blocked. In order to ensure a reasonably fair distribution of goods among the people of the community, the government adopted a system of price control and rationing.

The happenings of the 1930's and the 1940's left undecided the ques-

tion whether price movements can maintain equilibrium in our economic system. The critics of the price-equilibrium theory claim that the price mechanism was able to function effectively only as long as the economic system was highly flexible—small business units with a low proportion of overhead costs. Now that overhead costs have become a major factor in the business world, and labor and capital have become increasingly immobile, the price mechanism works well only in "normal" periods. Once large surpluses or shortages appear, price movements cannot of themselves restore equilibrium.

The defenders of the free market deny that the difficulties of the 1930's and the 1940's prove the ineffectiveness of the price mechanism. They claim that the failure to restore balanced conditions was due to the unwillingness of people to wait for the natural developments of the free market. Instead, there came governmental interference with price movements, and this interference prevented the normal evolution to a state of equilibrium.

Economic equilibrium is not necessarily a good thing. When a drought causes a shortage of meat, and the price of meat rises, demand drops enough to balance supply and demand. Equilibrium is established until a later season brings a larger supply of meat. Meanwhile many low-income families cannot afford to buy meat. If a surplus of radios exists, the prices of radios drop. The lower prices stimulate demand and perhaps at the same time force some radio producers out of business. A balance of supply and demand may be achieved. But the lower prices of radios may make it difficult for radio manufacturers to pay good wages to their workers. Economic equilibrium means a balance of supply and demand, but not always at the level which is best for the community as a whole.

In studying this problem, it is important to keep in mind that every price is one person's income and another's cost. The high prices of wheat, cattle, and milk in the 1940's raised farmers' standards of living, but deprived many city families of an adequate diet. The low prices of clothing in the early 1930's were a boon to consumers, but these low prices meant sweatshops, bankruptcy, and growing unemployment. The development of such situations has raised the question as to how far the determination of the prices of goods and services should be left to the play of the free market. There has been discussion of a *just price* (as in the farm-price program) for every good and service, that is, a price for every good and service, to be set at a point which will give everyone in the community a "fair" real income. We do not know, however, whether a just-price system would be more successful than the free-market system in maintaining equilibrium and promoting the general welfare.

## Exercises and Activities

### I Dictionary of Economic Terms

economic equilibrium · immobility of capital · marginal enterprise · just price · marginal supply

### II Questions and Problems

1) (a) Explain how marginal production and marginal enterprises help to balance supply and demand. (b) Why is it easier to expand marginal production than to decrease it?
2) The free market is described as a market in which prices are free to fluctuate without interference. What kinds of interference are referred to? Give some examples of such types of interference.
3) How do the stores in your neighborhood shopping district illustrate the way in which the free market allocates the use of land?
4) Show how the free market is really a system of automatic rationing. How does it differ from wartime rationing? (See page 651.)
5) Discuss each of the following statements: (a) The price system is the regulator of economic activity. (b) The free market is the main reason for the high American standard of living. (c) Economic equilibrium is a theory, not a fact. (d) The free market served a useful purpose during the days when capitalism was young. What factors have made it increasingly difficult for the free market to preserve economic equilibrium?
6) "In a dynamic economic world, the economic factors are constantly changing but are always tending toward a state of equilibrium." (a) Explain. (b) List factors which tend to interfere with, or prevent, the reaching of equilibrium.

### III Things To Do

1) Draw a cartoon or picture to represent the statement on page 266, "Economic equilibrium is like the sea level."
2) In any college textbook in economics, look up and report on such topics as "Supply and demand schedules" and "The theory of normal price." (Advanced students only.)

# UNIT 7

## BIG BUSINESS AND PUBLIC CONTROL


36 COMPETITION AND MONOPOLY

37 BIG AND SMALL BUSINESS

38 BUSINESS COMBINATIONS

39 CONTROL IN THE GIANT CORPORATION

40 METHODS OF COMPETITION

41 THE CONTROVERSY OVER "BIGNESS"

42 THE ANTITRUST LAWS

43 PUBLIC UTILITIES

44 GOVERNMENT AND BUSINESS

# LESSON 36 COMPETITION AND MONOPOLY

### THE DIFFICULTY OF DEFINING MONOPOLY

A major question today is whether there is more competition or more monopoly in the American economic system. One reason for the difficulty of answering this question is that there are many kinds and degrees of competition and monopoly.

Perfect competition and perfect monopoly are the two extremes. *Perfect competition* means that there are many sellers and buyers, none of them outstandingly large or influential.[1] As a result, the decision of any one or a few sellers regarding supply or price does not make any real difference in the market. The individual seller or buyer has to accept the price which is determined by the bargaining and competition of the market. It has been pointed out that nearly perfect competition is found in the organized securities and commodity markets. Yet even in these organized markets competition is not perfect, because some traders are able, through superior knowledge and various types of manipulation, to exercise greater influence on the market than the other traders can exercise.

Monopoly means that there is no competition. Perfect monopoly is probably impossible. Before World War II, one company produced all of this nation's aluminum, and another company produced all of this country's magnesium. Neither company had a perfect monopoly, however, because aluminum and magnesium were possible substitutes for each other, so that there was competition between the aluminum monopoly and the magnesium monopoly. There are other factors which also prevent the existence of perfect monopoly.

The term *monopoly* is therefore used in a relative sense. It refers to a situation in which a seller (or combination of sellers) controls a sufficient portion of the supply to exercise influence over the price. Instead of accepting the price, the monopolist determines the price. Actual markets are mixtures, in varying degree and kind, of competition and monopoly, and may be described by the term *monopolistic competition.*

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[1] The discussion of monopoly in this book deals with the selling side of the market. In some advanced books the term *monopsony* has been used to indicate concentration of power on the buying side of the market. Monopsony is relatively rare and seems to have less consequence. See Corwin D. Edwards, *Maintaining Competition,* McGraw-Hill Book Company. New York, 1949, pp. 95–97.

## Factors Influencing Degrees of Competition and Monopoly

A group of economists studying the extent of competition and monopoly in the American economy concluded with this statement:[2]

> No sort of estimate concerning the comparative extent of competition and monopoly in American markets is justified by the available evidence . . . . Competitive industries have their monopolistic aspects; monopolistic industries have their competitive aspects. The situation in both fields is constantly in a state of flux. The most that can be said today is that competition is far too common to justify the thesis that the competitive system is approaching extinction, and that monopoly is far too common to justify its treatment as an occasional exception to the rule.

### COMPETING AND MONOPOLISTIC MARKETS

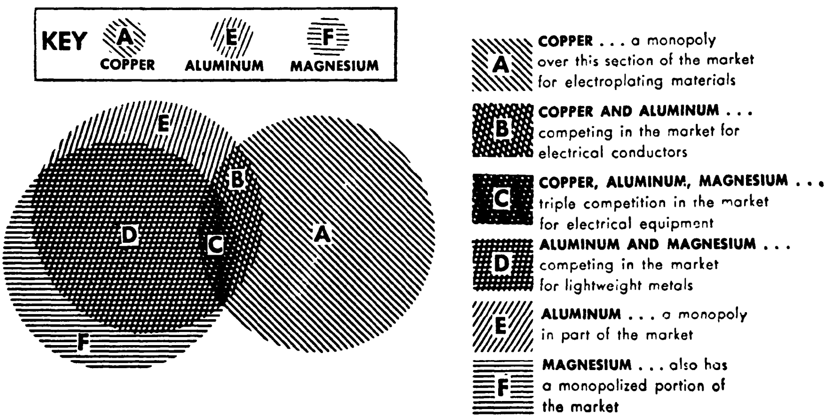


Chart by GRAPHICS INSTITUTE, N. Y.

**Each shaded circle represents a theoretically perfect monopoly. Yet the different monopolistic products compete with each other in some uses. Only in the part of the market where the circles do not overlap could monopoly be said to be complete.**

Whether the monopolistic or the competitive element will be stronger in any given situation depends upon several factors. First is the extent to which adequate substitutes exist. There can be competition among entirely different products which can be substituted for one another, as in the case of aluminum and magnesium. Moreover, a firm may have practically perfect monopoly in selling its product for some uses and at the same time have keen competition in selling it for other uses. In the diagram on this page an attempt has been made to show the variety of market situations arising where aluminum, magnesium, and copper,

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[2] Clair Wilcox, *Competition and Monopoly in American Industry*, TNEC Monograph No. 21, Government Printing Office, 1940, p. 308.

all assumed to be single-firm monopolies, compete with one another. It will be noted that each seller may have a monopoly in some uses, competition from one other product in other uses, and competition from both rival products in still other uses. Were the diagram to try to show the other metals, like steel alloys, nickel, and silver, the complexity of the competitive situation would be even greater.

Competition may be keen even when all the sellers have been granted legal monopolies under *patent* laws. A patent grants exclusive rights to sell or use a process for a period of seventeen years. If no other process is known which can serve the same purpose, the patent holder may have practically a perfect monopoly. Such would be the case, for example, if the process for atomic fission were a private monopoly instead of a government monopoly. Most patented articles, however, face competition from substitutes.

The businessman seeks to limit competition by giving his product a brand name and advertising it, in an effort to build the impression that there is no substitute To the extent that he succeeds in differentiating his product from the others and establishes a strong preference for his brand, he creates, in a sense, a single-firm monopoly. The less standardized the article, the greater the degree of differentiation; and the less obvious the possibility of substitution, the greater is the amount of monopoly power. Yet competition cannot be ignored. Excessively high prices or inferior quality will encourage customers to search for substitutes.

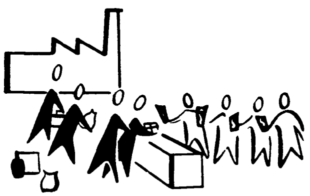
A second factor is the number of sellers and their relative size and strength. The greater the number of sellers and the smaller their size, the greater is the degree of competition. The smaller the number of sellers and the larger their size, the greater is the possibility for monopoly power. The fewness of producers makes consultation and coöperation easier.[3] In fact, where there are only a few large producers in the market and they consult and coöperate completely, the result may be just as if there were only a single producer.

Often there will be one or two very large concerns which may be in a position to dominate the market. Thus, in the steel industry it is common to speak of "Big Steel," meaning the United States Steel Corporation, and "Little Steel," including the Bethlehem Steel Corporation and a few other large companies which do not measure up to U.S. Steel. The claim has been made that for many vears the steel industry followed the lead of U.S. Steel in price and production policy. Such a

[3] A term which is used to refer to a market situation in which a few producers control production is *oligopoly*. The prefix "oligo," meaning "few," emphasizes the fact that there may be market control even though there may be more than just a single ("mono") producer (or "monopoly").

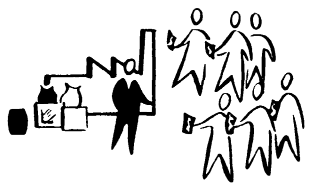
situation of "following the leader" is often referred to as *price leadership* or *market leadership.* It is likely to be most effective where there are relatively few firms. Leadership by a large firm is an element making for the strengthening of monopoly. The diagram below shows two forms of monopolistic competition, and the contrast with perfect competition and perfect monopoly.

## TYPES OF MARKET SITUATIONS



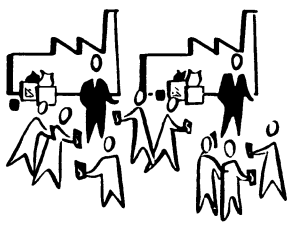
**PERFECT COMPETITION**

Many buyers and sellers, with an undifferentiated product or with substitutable ones. No individual's supply or demand, if removed from the market, is sufficient, by itself, to affect price.



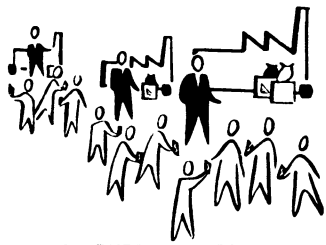
**PERFECT MONOPOLY**

Many buyers and one seller, with no competing substitutes, creates perfect selling monopoly. Obviously such a seller can fix the price which suits him best and vary supply accordingly.



**MONOPOLISTIC COMPETITION**

A few sellers, who may actively compete for sales, yet may cooperate more easily than a larger number of sellers, to influence price and control supply.



**MARKET LEADERSHIP**

Another example of monopolistic competition. Here again there are few sellers, but one seller is large enough so that the others follow his leadership.

Chart by GRAPHICS INSTITUTE, N. Y.

PRICE AND PRODUCTION IN MONOPOLISTIC COMPETITION

When the number of competitors is small, there is little to be gained from cutting prices. "Each large seller is likely to believe that aggressive competition will evoke aggressive retaliation by the other large concerns and that to live and let live is more profitable."[4] The small number

[4] Corwin D. Edwards, *Maintaining Competition,* McGraw-Hill Book Company, New York, 1949, page 94.

of firms can watch one another and quickly match any price-cutting maneuver; and the competitors of any one firm are too big to be easily driven out of business by price cutting by that firm. Realizing that price wars might finally ruin them all, they feel that, in the long run, all will be better off if each is satisfied with a certain share of the total business available. Whatever attempts are made to take business from one another are usually based on "quality appeal" rather than on "price appeal." Their advertising is centered in slogans aiming at building recognition of, and preference for, the brand, rather than stressing bargain prices. Special services, appeals to fashion, and elegance of packaging are used, instead of price cuts, as the means of winning customers. Such competition may be vigorous, but it is largely non-price competition.

The businessmen in these industries indignantly deny that competition is lacking. They point to the continuous struggle to maintain market position and to the large sums of money spent for advertising and for research to improve the product. They point to the burden of rising costs and to the fact that bankruptcy still occurs.

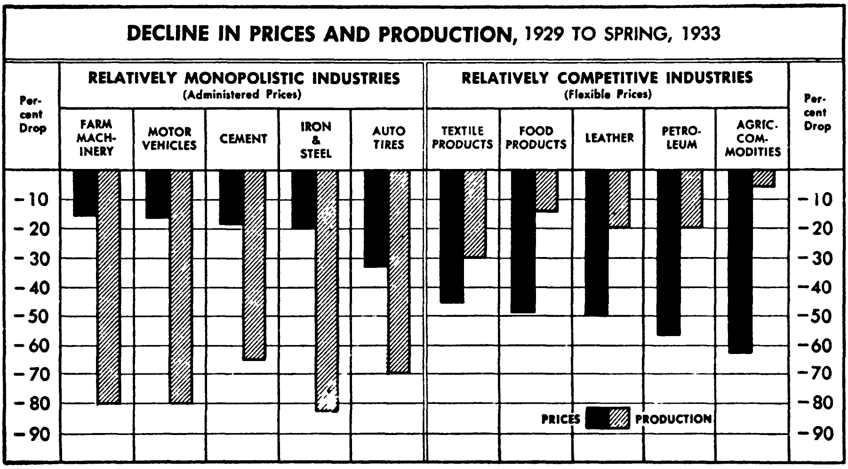
Yet it is evident that, however much these businessmen compete, they do not indulge in price competition like that of many other industries. Such a situation cannot be called monopoly, because there is enough competition to provide some check on prices and to stimulate improvements in quality and service. Yet it cannot be considered fully or freely competitive. In industries having monopolistic competition, the prices have remained stable for long periods of time, responding slowly to changes in demand. Price wars, occurring occasionally, have lasted only for short periods. The prices of competing brands have often risen and fallen together, at about the same time and by about the same amount.

Some evidence of the effect of monopolistic competition on prices and production is given in the chart on page 280.

During the 1930's, a period of depression, severe price competition was chronic in some industries, such as farming, coal mining, oil drilling, and textile and clothing manufacturing. In some other industries, such as the automobile, farm-machinery, steel, and cement industries, cutthroat competition did not appear. The reaction in these industries to the drop in demand was not to slash prices, but rather to reduce production. In competitive industries, prices were flexible, while production remained fairly stable. In monopolistic industries, prices were more inflexible, while production dropped considerably.

There has been much difference of opinion about the effect of price inflexibility in key industries upon the economic system. The restriction of output, by means of which prices have been kept stable, has been described as an important reason for the unemployment and reduction

in purchasing power which stalled the whole economy during the depression of the 1930's. Had prices been cut, it is argued, the demand for goods would have been stimulated, and production and employment would have gone up. On the other hand, the sharp price cuts in the competitive industries have also been considered a factor which created depression conditions. Cutthroat competition, it is claimed, caused business failures, unemployment, and substandard wages, and kept demand from rising. Whatever the effect of flexible and inflexible




In each of the industries at the left of the graph the percentage drop in price (shown by the black bar) was less than the percentage drop in production (shown by the shaded bar). In each of the industries at the right the reverse was true. In the second group, prices were more flexible than production; in the first group, production was more flexible than prices. (Data from Senate Document No. 13, 74th Congress)

prices upon business conditions, one thing is clear: prices have been more stable in industries in which there have been fewer competitors, highly differentiated products, and a greater degree of monopoly power.

### Limitations on Monopoly Power

Monopoly power is neither unlimited nor permanent. The monopolistic firm must keep in mind certain factors which limit its freedom in fixing selling prices and which tend to bring new competition.

First, the monopolist must consider the effect of price changes on the demand for his product. If the demand is elastic, he may make more profit by lowering the price and getting a larger volume of sales. This has been true, for example, in the selling of aluminum and of telephone

service. If the demand is inelastic, it may be more profitable to keep the price high, since a lower price would not increase demand significantly.

Even in such cases, however, the monopolist must watch a second factor, the possibility of substitute products. A high price for the monopolized product stimulates industrial research for new products and new processes which may reduce the need for the monopolized product. The development of lightweight metals, for example, has helped to offset tendencies toward monopolistic control of the supply of steel.

Another factor which has been used to check monopoly power is legal restriction. The mere threat of government interference acts to some extent as a restraining influence on the policies of monopolistic industries. For the past half-century the federal and state governments have used various types of legislation in an effort to control monopoly.

## Exercises and Activities

### I Dictionary of Economic Terms

monopolistic competition
patent
monopoly
perfect competition
price or market leadership

### II Questions and Problems

1) Explain how monopoly may be imperfect even when there is only a single seller.
2) Explain how each of the following may encourage the development of monopoly: (a) a scarce supply of a raw material in nature, (b) a patent or a copyright, (c) the need for huge capital to start an enterprise.
3) It has been said that control by a single buyer (monopsony) is less dangerous to the community as a whole than control by a single seller (monopoly). Do you agree? Explain your reasons.
4) Show how both competition and monopoly may enter into each of the following market situations: (a) a single firm produces all of a staple, unbranded product, a metal for example; (b) three firms share equally in the total output of a staple, unbranded product; (c) sixty firms produce the output, but one firm produces 40% of the total; (d) 120 firms sell identical products but under different brand names.
5) Explain what is meant by "non-price competition."
6) Prove from the graph on p. 280 that in some industries prices are more flexible than production while in others the reverse is true.
7) The Supreme Court has said that "mere size does not necessarily mean monopoly." (a) List arguments that might have been given in

favor of this opinion. (b) List arguments that might have been used in criticizing the statement.

III THINGS TO DO

1) Visit your local food, drug, or hardware stores. List the products that are sold without brand names. Ask the dealer whether he prefers to handle branded or unbranded merchandise, and why. Report to the class.
2) Those who have an interest in science may want to report on how each of the processes listed below works, and whether it had any effect in creating or discouraging monopoly in the industry. (a) The Frasch process for mining sulphur, (b) the Hall process of aluminum production, (c) the process (Owens) for making glass containers, (d) the process of drilling for petroleum.
3) Read (a) *Business in a Democracy,* and *Patents and Inventions,* pamphlets prepared by the National Association of Manufacturers. These give an account of the advantages of big business and express the point of view that big business is competitive business. (b) *Cartels or Free Enterprise* by Thurman W. Arnold (Public Affairs Pamphlet No. 103). This pamphlet discusses the dangers arising from big business. (c) *The Modern Economy in Action* by Ware and Means (Harcourt, Brace). This is a short book but is difficult reading. This book presents the point of view that our "competitive system" has completely altered in character. Able students should find the first thirty pages, setting forth the distinctions between the old and new economies, readable.

# LESSON 37 BIG AND SMALL BUSINESS

## CONCENTRATION IN BUSINESS

The names of American big businesses are as familiar to us today as the names of our neighbors. General Motors, Standard Oil, R. H. Macy, Proctor and Gamble, A & P, American Telephone and Telegraph, and many others—we read these names in the news and advertisements. These firms sign our pay checks, sponsor our radio programs, and provide many of the goods and services which we use from day to day.

Large corporations own, or control the use of, the bulk of our productive facilities. Just before World War II, it was estimated that the 200 largest nonfinancial corporations (that is, in manufacturing, mining, and trade rather than in banking and finance), owned about 45 percent of the assets of all corporations in those industries. In manufacturing, the 250 largest corporations, about ¼ of 1 percent of the total number,

owned about two-thirds of the nation's productive facilities.[1] In a later investigation an official of the Federal Trade Commission testified that there were 113 corporations in this country with assets of over 100 million dollars each. The 113 companies, he said, owned 43 percent of the assets of all the 90,000 manufacturing corporations in the country.[2] This disproportionate ownership of capital and assets is called *concentration of ownership.*

Many of our manufacturing concerns are giant in size and require tremendous amounts of capital. This photograph of a steel mill shows only a partial view, yet the space and equipment shown is probably greater than that taken by the many small enterprises in the photograph of Main Street in this lesson. (From *Steel Town*)

Big business employs a large proportion of those who work for wages or salaries; that is, there is also *concentration in employment.* In 1944 it was estimated that slightly over 2 percent of all manufacturing businesses were large enough to employ 500 employees or more. This small

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[1] Raymond W. Goldsmith and Rexford C. Parmelee, *The Distribution of Ownership in the 200 Largest Non-Financial Corporations,* TNEC Monograph No. 29, Government Printing Office, 1940.

[2] *Monopolistic and Unfair Practices,* Hearings before Subcommittee No. 1 of the Select Committee on Small Business, House of Representatives, 80th Congress, second session, 1948, pp. 1261–1263.

percentage of employers accounted for 62 percent of all employment in manufactures.

The growth in the size of business units is reflected in the changes in the extent of independent enterprises. According to a study by the Brookings Institution, in 1880 a little over 35 percent of the working population was self-employed in farming, business, or the professions. By 1939 the percentage of self-employed had fallen to under 20 percent.[3] An increasing percentage of the American people are working for large business enterprises, rather than in their own offices, stores, and shops.

The most important measure of the importance of big business lies in the proportion of the nation's goods and services it produces; that is, in the degree of *concentration in production.*

In many manufacturing industries, one concern or a very few concerns produce the bulk of the nation's output. When experts for a committee of Congress analyzed the production of 1,807 products, they discovered the following facts:[4]

| *In the case of* | *The four leading producers manufactured* |
|---|---|
| ¾ of the products | 50 percent of the total output |
| ½ " " " | 75 " " " " " |
| ⅓ " " " | 85 " " " " " |

The table on page 285 summarizes some of the evidence with respect to concentration in production in specific industries as reported in a later congressional investigation.[5]

War Production and Size of Business

The significance of big business was brought sharply home during World War II, when there was an immediate need for the expansion of production. From June, 1940, to September, 1944, over two-thirds of prime war-supply contracts went to 100 large corporations; one corporation, General Motors, received almost 8 percent of them. Most of the plant facilities erected with federal funds were operated by big business, largely because big firms had the experience and "know how" needed to expand output immediately and efficiently.

The effect of limitless demand for particular products, and of finan-

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[3] "Economic Concentration and World War II," *Report of the Smaller War Plants Corporation*, Government Printing Office, 1946, pp. 15, 24.

[4] Willard Thorp and Walter F. Crowder, *The Structure of Industry*, TNEC Monograph No. 27, Government Printing Office, 1940.

[5] *Monopolistic and Unfair Practices*, Hearings before Subcommittee No. 1 of the Select Committee on Small Business, House of Representatives, 80th Congress, second session, 1948.

CONCENTRATION OF PRODUCTION IN SELECTED INDUSTRIES

| *Product* | *Year of Data* | *Number of Leading Producers* | *Percentage of Total Output* |
|---|---|---|---|
| Magnesium | 1948 | 1 | 100 |
| Sewing machines | 1940 | 4 | 100 |
| Sheet aluminum | 1948 | 3 | 97 |
| Diesel locomotives | 1947 | 3 | 90 |
| Linoleum | 1947 | 3 | 90 |
| Rubber tires | 1945 | 4 | 90 |
| Copper refining | 1947 | 3 | 88 |
| Tin cans | 1939 | 2 | 84 |
| Cigarettes | 1947 | 3 | 83 |
| Soap | 1939 | 3 | 80 |
| Automobiles | 1948 | 3 | 79 |
| Tinplate | 1945 | 5 | 79 |
| Agricultural machinery | 1940 | 3 | 67 |
| Electric refrigerators | 1941 | 4 | 66 |
| Steel ingots | 1945 | 3 | 59 |
| Wool carpets and rugs | 1947 | 4 | 59 |
| Petroleum | 1947 | 4 | 49 |

cial assistance by a government desperate for war goods, enabled some small businesses to grow quickly to big-business scale. This was notably true in the aircraft industry. In the production of aluminum, which prior to the war had been entirely in the hands of the Aluminum Corporation of America, the government financed the entry of a new concern into the field, thus lessening the monopolistic situation. But, although the war hastened the growth in size of smaller business units, it temporarily decreased the number of business establishments in existence. This was mainly the result of the shortage of materials and of manpower. This decline was reversed immediately after the war, as a result of the large supplies of materials and manpower, and also because of the financial help given to veterans under the business loan provisions of the "GI Bill of Rights." To assist veterans to establish themselves, the government undertook the publication of numerous pamphlets on the problems of small business in various fields in which there was a possibility of a small beginning. The failure rate among small businesses, however, has always been considerable, and it is uncertain whether the increase in the number of business enterprises will be permanent.

## CAUSES OF CONCENTRATION

A fundamental reason for the domination of industry by big business has been the efficiency of large-scale production. As explained in Lesson

30, a large enterprise can use technological improvements, such as specialization, mechanization, standardization, and precision methods. These methods reduce cost per unit and bring greater sales and profits.

Another important reason for the spread of big business comes from the bargaining advantages derived from large-scale operations. A multi-million-dollar business, with its huge demand for materials and equipment, is in a better position to get low prices when buying. It is in a position to exercise strong influence over customers who need its products. Its connections with large financial institutions make it easy to raise large amounts of capital through loans and sales of securities. These advantages make it increasingly difficult for small businessmen to compete successfully with the large firms. Moreover, in many fields new competitors have been few because of the large amount of capital needed to enter into large-scale operations.

Another reason is the geographic factor. Whenever a raw material or a location of particular merit is scarce in nature, it becomes easier for one or a few firms to gain complete control of it. This helps to account for the control of sulphur production by two companies, and of aluminum production by one major company (until recently); and for the monopoly in magnesium, iron ore, and other minerals. The fact that anthracite coal is found principally in one area, about 20 miles by 20 miles in Pennsylvania, while bituminous coal is found in many states, helps to account for the greater degree of monopolistic control in anthracite production.

Another factor in the growth of big business is the legal factor. Examples of *legal monopoly*, or a grant of monopoly by law, are the patent and the copyright. A patent grants a monopoly on the manufacture, sale, and proceeds of an invention for a term not exceeding 17 years. A *copyright* is a monopoly granted to writers preventing the reproduction of their works without consent, for a period of 28 years, with the right to renew it for an additional 28 years. *Trademarks*, such as a brand name, slogan, or symbol, may be registered under the patent laws for a period of 20 years, after which they may be again registered. The Hall process for producing aluminum electrolytically from bauxite is an example of a patented process which has contributed to the development of monopolistic control in this industry. Another example of legal monopoly is the *franchise*, which is granted to gas, electric, telephone and other public-utility companies; this generally gives one company exclusive right to lay wires, pipe, or rails or to operate in a given area.

A fourth factor may be termed the advantage of an early start. Most of the existing large corporations have a long history of growth. The names of the companies and their products have the prestige which

results from age and advertising. Their sources of supply and business connections are well established. It is difficult for a newcomer to break in. Bankers and suppliers of materials and funds may hesitate to assist the newcomer lest they lose the friendship and business of the established leaders in the field.

### The Survival of Small Business

In every industry, and for every product, there is some concentration, but in some cases this concentration is relatively insignificant. There

*Standard Oil Co. (N.J.), photo by Webb*

**Main Street has been called "the axis of small business." Note the variety of retail establishments shown in this section of the Main Street of this New England town.**

are from five to six million farms in the United States, and even the largest among them produce only a small proportion of the total output. There are thousands of small retail, wholesale, and service establishments. Despite the growth of chain and department stores, retailing has remained a stronghold of small business. There are a great many small firms in various lines of clothing, printing and publishing, trucking, bituminous coal mining, oil drilling, fishing, construction, and other fields.

There are several reasons which explain the survival of small business in so many fields. In some industries, as in agriculture and fishing, natural factors place a limit upon the technical benefits of large-scale operations. Some types of business are by their very nature small busi-

nesses, for example, the custom tailor, locksmith, or florist. In some fields, such as trucking, it is possible for small firms to operate profitably on a low-cost, cut-price basis, and thus compete successfully with the large firms in that field. Even in the industries controlled by big business, such as steel and automobiles, there are specialties which are produced on a small scale and which provide opportunities for relatively small firms. Finally, in a free-enterprise community it is inevitable that resourceful and daring individuals will discover new ways of making money. While small firms fall by the wayside each year, others take their places.

In terms of numbers, small business may be considered typical of the American economy. From the viewpoint of volume of business and extent of economic power, big business becomes increasingly significant.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| concentration of production | copyright |
| concentration of employment | franchise |
| concentration of ownership | legal monopoly |
| patent | trade mark |

### II Questions and Problems

1) Give at least one reference to this textbook to support each of the following statements: (a) There is concentration of ownership in American industry. (b) There is concentration of employment in American industry. (c) There is concentration of production in American industry. (d) Despite industrial concentration there is still a considerable amount of small business.
2) List and explain four factors encouraging concentration. (b) State and explain two reasons for the survival of small business in some industries.
3) (a) Why did large firms get a larger proportion of war contracts than did small firms? (b) How did war create possibilities for small manufacturing businesses? (c) How did war create difficulties for some types of small businesses?
4) What factors may help to explain the persistence of small business in farming and retailing?
5) How is the supply of housing affected by the fact that the contract-construction business is small business? (Consult Lesson 12.)

### III Things To Do

Read (a) Novels, biographies of industrial leaders, and histories of our giant firms, which are available in great numbers. Upton Sin-

clair is famous for *The Jungle,* a book dealing with conditions in the meat-packing industry before World War I, and has written many others. Lincoln Steffens, another of the muckraking writers of the early part of the century, deals with the influence of business in politics in his *Autobiography. The Robber Barons* by Matthew Josephson, and *The Lords of Creation* by F. L. Allen are well-known critical treatments of business. *The House of Morgan* by Lewis Corey; *Andrew Mellon* and *The Guggenheims,* both by Harvey O'Connor; *Imperial Hearst* and *America's Sixty Families* by Ferdinand Lundberg, *J. P. Morgan* by Winkler; and *God's Gold* (Rockefeller) by John T. Flynn are examples of biographies and histories of industrial leaders and firms. *The Valley of Decision,* a novel by Marcia Davenport, is a story about the growth of the steel industry. Carey McWilliams, in *Factories in the Field,* discusses the effects of growing concentration in farming. Many issues of *Fortune* magazine, which may be on file in your library, have richly illustrated articles dealing with the histories and problems of prominent American firms. (b) *Industry in America* by Charles H. Seaver (Harper, 1946). A simply written high school textbook on the growth of American industry.

# *LESSON* 38 BUSINESS COMBINATIONS

## The Aims of Combination

Business firms have grown to giant size in two ways: (1) by inner expansion, and (2) by the combination of two or more firms into one. *Combination* is the means by which different firms are joined together under one control, or by which they are made to operate with a single policy. It may result from the formation of one firm where several existed before; or it may result from coöperation among a number of independently owned firms. There are three major types of combinations: *horizontal, vertical,* and *circular;* these differ from each other in major aims.

When firms selling competing products are combined, there is said to be a horizontal combination. Many industrial giants like United States Steel, International Harvester, and Anaconda Copper were developed partly through horizontal combinations.

Horizontal combinations are usually justified on the ground that they bring the benefits of large-scale operations. More specialization, greater efficiency in the use of plant and equipment, quantity buying of materials, savings in shipping costs, reduced advertising and selling costs

per unit—these are some of the possible results of horizontal combination. If such results are realized, the combination may represent economic progress.

In some cases, however, the chief aim of the horizontal combination is to reduce the number of competitors, so that it will be easier to control production and price policies. Some combinations have been arranged to make possible profitable transactions in securities. In the cement combination described in the diagram on page 296, the idea originated with a group of investment bankers, who made a profit of five million dollars from the sale of the securities of the new corporation. In the many combinations which have taken place during the past century, the three aims—greater efficiency, lessening of competition, and financial profits—have often been intertwined.

Vertical combination, or *integration,* is the combining of steps in the production and distribution of a product. The Standard Oil Company controls oil wells, pipe lines, refineries, and service stations. The Ford Motor Company not only manufactures automobiles, but also owns coal and iron mines, a railroad connecting the mines, steel mills, sales agencies, and a credit corporation to finance installment sales. The Great Atlantic and Pacific Tea Company (A & P) has bakeries, cheese-processing plants, creameries, canneries, coffee-roasting plants, laundries, and a printing plant.

Vertical combinations may have several purposes. The copper-mining company which also operates copper refineries has an assured outlet for the raw copper; it may also find it more profitable to sell the refined copper than the raw copper. The large steel producers and railroads own coal mines (often referred to as "captive mines"), in order to control the supply of a raw material of great importance to them. The clothing manufacturer who has his own chain of retail stores may be able to undersell most of the independent clothing stores and thereby get a volume of business which he could not achieve if he operated merely as a manufacturer. It must be remembered, however, that vertical combination increases the amount of capital involved and the risks from a decline in the volume of business.

The circular combination combines firms selling products which, though different and not directly competing with each other, are sold through the same marketing channels. It is common in the food and drug industries. General Foods Corporation is a combination of companies selling breakfast cereals, coffee, gelatine desserts, tapioca, syrups, cocoa, chocolate, salt, baking powder, cake flour, fruit juices, frozen foods, tea, starch, canned vegetables and fruits, bluing, dog food, and cat food. The major aim of such a circular combination is to avoid duplication of selling expenses. The entire line of goods can be

sold by one salesman, delivered by the same trucks, and advertised on the same radio program; and the brand prestige of one item may be used to push others in the line.

### Coöperation and Combination

Any arrangement by which a group of firms follows a single market policy accomplishes the effect of combination. It may be done by coöperation or agreement among several firms, by devices for giving several firms common direction or management, or by replacing several firms with a single firm.

Businessmen have found consultation and coöperation useful. The most frequent means used by businessmen to handle common problems collectively is the *trade association.*

A trade association is a voluntary association of independent business firms in a given trade, industry, or area, organized for the purpose of representing the industry or area and serving the interests of the members. The trade association is not itself a business firm. It may go by a variety of names, such as the Maple Flooring Manufacturers Association, the American Iron and Steel Institute, the Millinery Quality Guild, or the New York Board of Trade. It may undertake market surveys, do coöperative research to develop new uses for products, advertise the values and services of the product and the industry to the public, provide traffic or transportation information, maintain employment agencies, deal with trade unions, publish trade journals, represent the industry before agencies of the government, engage in publicity and legal work, and carry on lobbying (the influencing of legislators) in Washington and in state capitals.

Trade associations sometimes undertake activities which may have the effect of lessening competition. For example, they may standardize products, methods of accounting, terms of credit, discounts, and other practices. Standardization helps to stabilize competition in the industry, but to the public it may appear as an effort to create a monopolistic situation. The trade association may go so far as to collect statistics of prices, costs, and sales, which are then tabulated and summarized for distribution to members. This is often referred to as a "price-reporting plan" or an "open-price association." Trade associations claim that by giving such information, they encourage competition among the members; but critics claim that this practice serves as a device for achieving understanding among members as to what the uniform price should be.

When coöperation is carried to the point where there is uniformity in price policy, it may be regarded as monopolistic activity. An extreme example of such activity is the practice of submitting identical bids. Thus, in 1934, bids were received by the government from nine lead-

ing steel companies for steel plates to be delivered to the Boston and the Norfolk Navy Yards. The bids of the nine competitors were identical to four decimal places ($.0228 per pound). The Federal Trade Commission, after investigating, claimed that the identical bids were the result of the activities of the trade associations in the steel industry.[1]

### Combination by Agreement

It is not necessary for business firms to have formal organization in order to fix prices, control output, or divide up the market. An informal understanding is enough, provided the parties live up to it. From 1907 to 1911, for example, the annual dinner meetings of the heads of steel companies (known as the "Gary Dinners" because they were presided over by Judge Gary of United States Steel), apparently served as a means of arranging agreements on output and prices. There were no formal agreements, and each company was free to do as it pleased. But, if each "followed the leader," the effect could be the same as a formal agreement. Because these agreements could not be legally enforced, and relied for their success upon the willingness of each producer to "play ball," they came to be known as *gentlemen's agreements,* informal agreements among businessmen to limit competition.

A *pool,* or *cartel,* is a more formal agreement among businessmen aiming at control over market conditions. In this country, we have used the term "pool" for such arrangements in domestic trade, and the term "cartel" for such arrangements in international trade. Generally a pool is operated through a special agency set up for the purpose. There are several kinds of pools. An output pool fixes the desired total output for the industry, and then assigns a specified share of the total to each member. A market, or territorial, pool divides the market among its members. In 1902, the Imperial Tobacco Company (British) and the American Tobacco Company (U.S.) agreed to divide the world into three parts; the British company was to have exclusive rights in the British Isles; the American Company was to serve the United States, its possessions, and Cuba; and the business in the rest of the world was to be handled by a new company formed for the purpose. In the income, or profits, pool the members agree to make a common fund of profits, and to share them on the basis of an agreed quota system. Whatever form of pool is used, the purpose is to eliminate competition. Since each member is assured of its share of the sales or profits, there is no incentive to expand output or to cut prices.

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[1] *Report of the Federal Trade Commission to the President With Respect to the Basing Point System in the Iron and Steel Industry,* November, 1934, Government Printing Office, 1935, p. 5.

A special kind of pooling arrangement is the *patent pool*, in which the members agree to turn over their patents to a central agency. This agency then has the job of granting licenses to businessmen to produce under the patents. The members may be granted free use of each other's patents, or they may be required to pay a uniform fee or royalty for the use of the patents. A patent pool, by making patents available to all under uniform conditions, may serve to prevent monopoly. On the other hand, if those who are granted licenses to use the patent are required to restrict production or fix prices, the patent pool becomes a device for curbing competition. In the 1920's, General Electric, Westinghouse Electric, the American Telephone and Telegraph Company, and the United Fruit Company pooled their patents with the Radio Corporation of America. The Department of Justice, in bringing suit, charged that it was a means of dictating prices on 95 percent of the radio sets sold. The companies agreed to dissolve the patent pool in 1932.

### Combination by Common Management

The major policies in a corporation are made by the board of directors. Therefore, one method of getting several corporations to follow a common policy is to have the same individual, or group of individuals, control the policies of the several boards of directors. Although the corporations continue to function as separate businesses, they may act with respect to price and production virtually as if they were one firm. This is *combination by common management;* that is, combination through providing single or coördinated management and direction of several firms.[2]

A widely used method of attaining this coördination of management policies has been the *interlocking directorate.* This means that the same individual, or group of individuals, serves on the boards of directors of different corporations. A director has access to the records and plans of the corporation he is helping to direct. As an "insider" in several corporations, the interlocking director can be a force for unifying their policies. This power may not be used for selfish gain or for monopolistic purposes. But when there are interlocking directorates among competing companies, the result may easily be a lessening of competition.

The diagram below shows the interlocking of directorships in three

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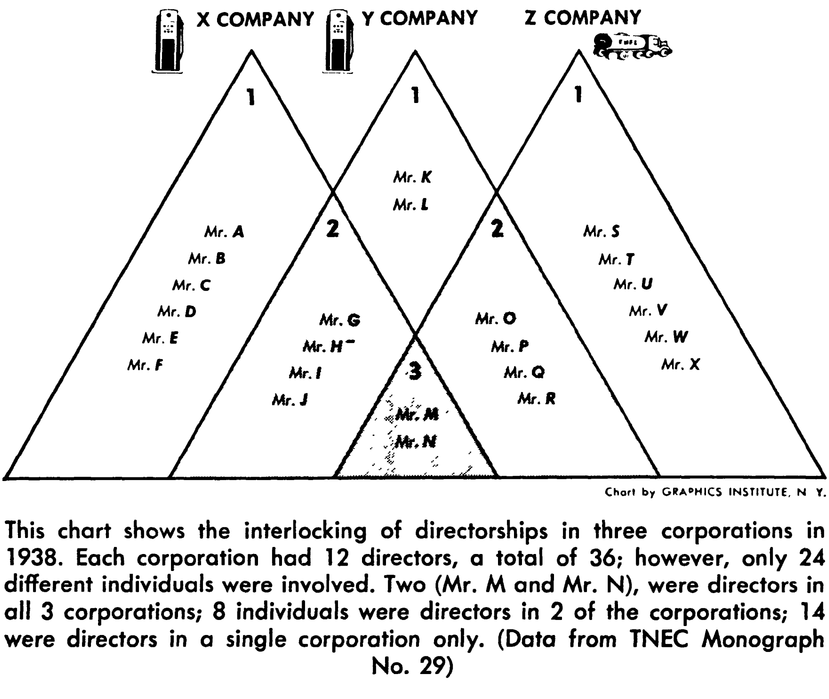
[2] An early device for achieving combination by common management was the *trust.* It was used mainly in the period of the 1880's and is described in many textbooks in American history. Although used for certain legal purposes, today it is not an important device for effecting combination. However, it contributed to our language its name, which refers popularly to any monopolistic business organization.

large corporations in September, 1939.[3] In the 200 largest nonfinancial, and the 50 largest financial, corporations in 1935, 488 persons were directors in more than one corporation; and one was director in nine.[4]

An interlocking directorate will frequently result from common ownership or "community of interest" in different corporations. The Rockefeller family owned the largest amount of voting stock in several Standard Oil companies. The Mellon family owned controlling interests in the Aluminum Corporation of America, the Pittsburgh Coal Company, the Gulf Oil Corporation, the Pittsburgh Plate Glass Company, the Kopper Company (coke), and other corporations. Many interlocking

**INTERLOCKING DIRECTORSHIPS IN THREE COMPANIES**




This chart shows the interlocking of directorships in three corporations in 1938. Each corporation had 12 directors, a total of 36; however, only 24 different individuals were involved. Two (Mr. M and Mr. N), were directors in all 3 corporations; 8 individuals were directors in 2 of the corporations; 14 were directors in a single corporation only. (Data from TNEC Monograph No. 29)

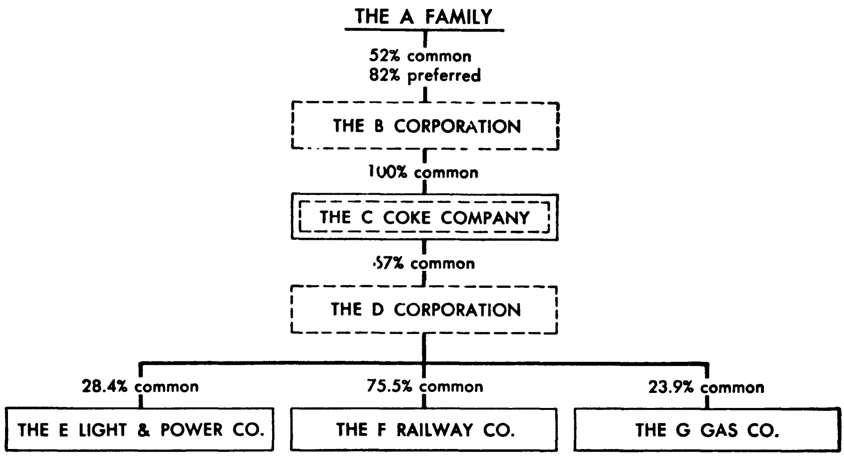
directorates, however, reflect the mutual interests of large industrial corporations and banking and financial institutions. In 1935, out of the 14 directors of Pullman, Inc., 2 were partners in J. P. Morgan and Company, and 4 were affiliated with the First National Bank, which in turn

[3] Raymond W. Goldsmith and Rexford C. Parmelee, *The Distribution of Ownership in the 200 Largest Non-Financial Corporations,* TNEC Monograph No. 29, Government Printing Office, 1940.

[4] *Structure of the American Economy: Basic Characteristics,* Part I; National Resources Committee, 1939, Table 3, p. 158.

was related to Morgan interests. A government study estimated that, in 1935, 106 of the 250 largest financial and nonfinancial corporations were included as part of the "interests" of 8 major banking groups. The largest of these groups, the Morgan-First National group, controlled almost 50 percent of the assets of the 106 corporations; included were some of the major corporations controlling the bulk of the business in their respective fields. The study said: "While it is certain that the extensive

**A HOLDING COMPANY ORGANIZATION IN 1937**




**This chart pictures the intercorporate relationships in an actual holding-company organization. Under each company is the percentage of the voting stock it owns in the subsidiary below. The dotted lines show holding companies; the solid lines show operating companies; dotted and solid lines show a holding and operating company. Thus the C Coke Company is an operating company (in the coke business), and also a holding company owning 67% of the stock of the D Corporation, which, in turn, is a holding company controlling three operating companies. (Data in TNEC Monograph No. 29)**

economic activity represented by those corporations is in no sense subject to a single, centralized control; it is equally certain that the separate corporations are not completely independent of each other."[5]

Another method of unifying the managements of different corporations is through a *holding company.* A holding company is a corporation which owns all or a controlling part of the shares of another corporation. The holding company is sometimes called the *parent company,* while the company whose shares are held by the holding company is called a *subsidiary.* Some corporations are organized for the sole pur-

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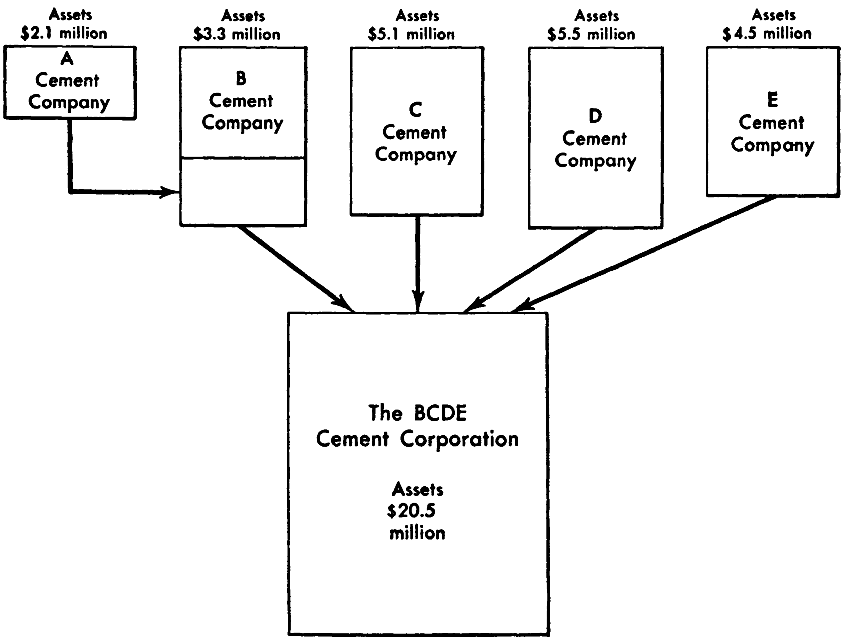
[5] *The Structure of the American Economy: Basic Characteristics,* Part I, National Resources Committee, 1939, pp. 161–162.

pose of owning other corporations; others may also be *operating companies*, producing goods and services. The DuPont Corporation, for example, operates a chemical business, and owns a substantial block of the shares of the General Motors Corporation. A holding company may be a subsidiary of another holding company, as shown in the diagram on page 295.[6] Note that the B Corporation was a holding company which owned all the stock of a holding and operating company, the C

**DIAGRAM OF A CONSOLIDATION OF CEMENT COMPANIES**




The boxes have areas in proportion to the assets of the corporation represented. A first *merged* with B. Later the enlarged B Company was *amalgamated* with C, D, and E to form the BCDE Corporation. (Data from TNEC Monograph No. 13)

Coke Company. The C Company owned most of the stock of the D Corporation, a holding company which owned varying percentages of the stocks of three operating companies.

Horizontal, vertical, and circular combinations can be arranged through a holding company. Those who control the holding company are in a position to choose the officers and directors of the subsidiaries and thus dictate the policies to be followed by the subsidiaries. If the

[6] Raymond W. Goldsmith and Rexford C. Parmelee, *The Distribution of Ownership in the 200 Largest Non-Financial Corporations*, TNEC Monograph No. 29, Government Printing Office, 1940, pp. 124–125.

subsidiaries sell the same or competing products, the common management may be a means of reducing competition.

### Combination by Consolidation

The most obvious and complete method of achieving horizontal, vertical, or circular combination on a permanent basis is to form one larger business enterprise where there were formerly several. This is commonly referred to as *consolidation.* When one of the existing corporations absorbs the other, we refer to the action as a *merger.* It can be accomplished through the purchase of the capital stock or of the assets of the firm being absorbed, by the one remaining in existence. Where an entirely new corporation is organized to absorb the others, there is said to be an *amalgamation.* The final effect is so much the same that the terms are used interchangeably.

The diagram on page 296 shows an actual example of two main methods of consolidation involving the same group of cement companies.[7] First the A Cement Company was absorbed by the B Cement Company, in a merger. Later an amalgamation took place when the BCDE Cement Company was organized to replace the B, C, D, and E companies, all of which were absorbed.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| amalgamation | horizontal combination |
| circular combination | interlocking directorate |
| combination | merger |
| combination by agreement | operating company |
| combination by common management | parent company |
| consolidation | patent pool |
| gentlemen's agreement | pool (or cartel) |
| holding company | subsidiary |
| | trade association |

vertical combination (or integration)

### II Questions and Problems

1) Explain or identify (a) community of interest, (b) open-price association or price-reporting plan.
2) Explain the purposes and services of trade associations.
3) (a) Explain how it is possible to have uniformity of policy although several independent firms continue to exist. (b) State and explain

[7] *Relative Efficiency of Large, Medium-Sized, and Small Business,* TNEC Monograph No. 13, Government Printing Office, 1941, pp 140 ff.

the three general means by which combination of policy may be achieved.

4) "Gentlemen's agreements have been so named because their maintenance was strictly voluntary. This explains their inadequacy." Explain.

5) The holding company diagram in this lesson illustrates integration of a coke company, a gas company, a power company, and a railroad. By reference to the diagram, explain the meaning of integration. What advantages might this particular integration have?

6) (a) Explain the meaning of "horizontal," "vertical," and "circular combination." (b) List the advantages and disadvantages of each.

7) Note the diagram which illustrates combination by the consolidation of firms. It shows both merger and amalgamation. By references to the diagram, explain the meaning of "consolidation," "merger," and "amalgamation."

8) Members of banking firms have often been found to be directors in several large corporations. What factors may help to explain this fact?

9) In 1936, the Nash Motors Company, manufacturer of automobiles, and the Kelvinator Corporation, manufacturer of refrigerators and air-conditioning equipment, both sent letters to their stockholders seeking consent for a merger. Prepare an outline setting forth possible advantages to the stockholders of each corporation.

10) The following is a quotation from *The New York Times,* February 15, 1939: "Robert G. Stanley, president of the International Nickel Company, has been nominated a director of the United States Steel Corporation to succeed Walter S. Gifford, president of the American Telephone and Telegraph Company. . . . United States Steel, as a large user of nickel and also as a result of its recent large-scale expansion of light and alloy steel production facilities, expects that the addition of Mr. Stanley to its Board of Directors will be of great importance."

    (a) Which type of combination is represented here? (b) The article suggests benefits to the U.S. Steel Corporation. How might stockholders of International Nickel benefit? (c) What may explain the fact that the president of a telephone company was a director in a steel corporation?

## III Things To Do

1) The following topics are very briefly referred to in this lesson. Make a more detailed report by consulting history texts, more advanced economics books, or an encyclopaedia. (a) How the trust form of combination worked. (b) How the Standard Oil Companies used the various forms of combination. (c) What the basing point system in the steel industry was. (*Steel—Problems of a Great Industry,* Public Affairs Pamphlet No. 15, 1937 is a source of information.) (d)

How the United States Steel Corporation came into existence. (e) How producers' coöperatives work and the extent to which they have the same aims as industrial combinations.

2) Read the chapters in your history textbook dealing with the growth of big business, the combination movement, or related topics. Note that each of the methods of combination described seemed to be most popular during a particular period. Report to your class on this aspect of the combination movement.

# LESSON 39 CONTROL IN THE GIANT CORPORATION

## The Dispersal of Ownership

When John Doe says that he owns all the capital stock, amounting to $50,000, in a corporation which operates a garage and service station and which has assets worth $75,000, we recognize it as a very possible situation. But when the Standard Oil Company of New Jersey announces assets worth over 2 billion dollars and capital stock outstanding worth over a half billion dollars, we may be sure that no one person, or even a few persons, have wanted to or been able to put up all that money. In all but a few cases. the ownership of the shares in our giant corporations is widely distributed among thousands of stockholders. It has been estimated that in 1939, American corporations had on their books the names of 26 million stockholders. Since many people held stock in more than one corporation, there were probably 8 or 9 million individuals holding corporate stock.[1] Included among these stockholders were not only individuals, but other corporations, banks, trust funds, estates, insurance corporations, churches, and other institutions.

The ownership of corporate stock is not so evenly distributed as the above figures would seem to indicate. A study made in 1937 showed that, of over 7 million owners of shares in the 200 largest nonfinancial corporations, about 88 percent of the stockholders had fewer than 100 shares each. The shares of this 88 percent, when put together, amounted to only 17.6 percent of the value of all the outstanding shares of the 200 corporations. On the other hand, only ¼ of 1 percent of the 7 million stockholders owned more than 5000 shares each. This small group owned 48.4 percent of the total value of shares outstanding.[2] The fig-

[1] Raymond W. Goldsmith and Rexford C. Parmelee, *The Distribution of Ownership in the 200 Largest Non-Financial Corporations*, TNEC Monograph No. 29, Government Printing Office, 1940, p. 13.

[2] *Op. cit.*, p. 36.

ures thus showed that, despite the dispersal of ownership among a large number of stockholders, there was a high degree of concentration of ownership.

According to this study, however, it was an exceptional case for a large percentage of the stock of a corporation to be owned by one holder. In each of the 200 largest corporations, the combined shareholdings of the 20 largest stockholders totaled less than 25 percent of the value of the outstanding shares. In many cases the largest stockholder was another corporation, a holding company. If such corporate holdings were left out, the proportion owned by the 20 largest individual stockholders was still smaller. In some of the largest corporations like the American Telephone and Telegraph Company and the Pennsylvania Railroad, no stockholder owned as much as 1 percent of the total stock.

The table below shows how the stock of fifteen well-known corporations was distributed at various times between 1937 and 1939.[3]

STOCK OWNERSHIP IN A SELECTED GROUP OF CORPORATIONS

| *Corporation* | *Date of Data* | *Kind of Stock* | *Voting Status* | *Number of Shares* | *Stock-holders* | *Percentage** *1* | *2* |
|---|---|---|---|---|---|---|---|
| | 11 26 37 | Common<br>Preferred | Voting<br>Nonvoting | 10,158,738<br>47,864 | 49,748<br>737 | 2.73<br>8.36 | 3.47<br>6.56 |
| AMERICAN TEL. AND TEL. | 12/15/37 | Common | Voting | 18,686,794 | 641,308 | 0.63 | .04 |
| ANACONDA COPPER | 3/19/38 | Common | Voting | 8,674,270 | 109,377 | 7.87 | .38 |
| ATLANTIC & PACIFIC | 12/29/39 | Common<br>Common<br>Preferred | Voting<br>Nonvoting<br>(a) | 1,150,000<br>935,812<br>260,362 | 1<br>5,876<br>8,340 | 100.0<br>61.7<br>36.01 | 40.00<br>35.75<br>29.22 |
| BORDEN COMPANY | 3/23/38 | Common | Voting | 4,396,704 | 47,595 | 2.67 | 1.89 |
| CONSOLIDATED EDISON | 2/11/38 | Common<br>Preferred | Voting<br>Voting | 11,476,527<br>2,186,792 | 95,338<br>26,220 | 2.50<br>5.56 | .19<br>.00 |
| FORD MOTORS | 12/31/38 | Common B<br>Common A | Voting<br>Nonvoting | 172,645<br>3,280,255 | 3<br>4 | 55.21<br>51.40 | 96.86<br>89.24 |
| GENERAL MOTORS | 12/31/37 | Common<br>Preferred | Voting<br>(a) | 43,500,000<br>1,835,644 | 363,005<br>20,819 | 27 02<br>2.72 | 6.26<br>.70 |
| PENNSYLVANIA R.R. | 12/13/37 | Common | Voting | 13,167,754 | 215,600 | .88 | .11 |
| R. J. REYNOLDS TOBACCO | 1/25/38 | Common B<br>Common | Voting<br>Nonvoting | 9,000,000<br>1,000,000 | 57,435<br>2,438 | 20.00<br>3.64 | 26.42<br>2.15 |
| SOCONY-VACUUM OIL | 2/21/38 | Common | Voting | 31,150,610 | 111,712 | 7.65 | .32 |
| SWIFT AND CO. | 8/1/37 | Common | Voting | 5,906,508 | 57,081 | .98 | 3.33 |
| U.S. STEEL | 3/4/39 | Common<br>Preferred | Voting<br>Voting | 8,703,252<br>3,602,811 | 167 740<br>66,808 | 3.71<br>3.26 | .21<br>.14 |
| WESTERN UNION | 12/31/37 | Common | Voting | 1,045,004 | 30,806 | 1.44 | 3.62 |
| F. W. WOOLWORTH | 11/10/39 | Common | Voting | 9,703,610 | 63,075 | 5.25 | 14.17 |

* 1—Held by largest stockholder of record
2—Held by *all* Officers and Directors
(a) Contingent voting, i.e. usually has no vote but may vote under special circumstances.

[3] *Op. cit.*, Appendix III, pp. 206–230; Appendix VII, pp. 374–531; Appendix XI, pp. 621–1482.

The table lists one corporation, the American Telephone and Telegraph Company, with about 650,000 stockholders (as of that time). There are twelve states in this country in which the population is no larger than the number of stockholders in this one corporation. The largest stadiums in the country would be inadequate for the stockholders' meetings of some of these corporations, if all the stockholders were to come. Even if so many people could be brought together for a meeting, it would be impossible for them to carry on discussions of corporation problems.

There have been some cases of giant corporations owned by one individual, family, or small group. When the stock of a corporation is owned by an individual or a small group and its shares are not available for public sale, we call it a *closed corporation*. It will be observed, from the table preceding, that at the end of 1939 one stockholder owned all of the voting stock of the A & P and large blocks of the other types of shares. Another example of a closed corporation was Ford Motors; Henry Ford was chief stockholder and the balance was divided among other members of the Ford family.

The fact that closed corporations are uncommon among giant corporations is revealed in the table. The first column of percentages, showing the percentage owned by the largest stockholder of record, lists only two corporations in which the proportion was over fifty per cent. In many cases the proportion was very small indeed. In many of the corporations listed, the largest stockholder was another corporation, or trustees for an estate or some organization. Also interesting is the fact that officers and directors are often owners of only a small proportion of the stock. This can be seen by observing the last column of percentages in the table, which gives the percent held by all the officers and directors combined. For the 200 largest corporations in 1937, the average stock ownership for all officers and directors combined was 5.5 percent.

### Separation of Ownership and Control

Ownership in a corporation means having a share in its capital. Control of a corporation means having the power to select its management —the directors and officers. Management in the corporation is the conduct of its daily affairs by the officers and directors. The terms "ownership," "control," and "management" are also used to refer to the individuals or groups who exercise these functions.

In small firms, ownership, control, and management go together. The same people are the owners, directors, and officers of the corporation. They decide the general policies and conduct the daily affairs of the business. Even in the medium-sized corporation, with several dozen or

a few hundred stockholders, there may still be a practical identity between the chief stockholders and management. As the number of stockholders increases, the gap between the stockholders and management widens. Instead of the control by majority ownership which exists in the small corporation and in the large closed corporation, there develops a situation which can be described as control by minority ownership.

*Courtesy of Cities Service Company, Inc.*

**Keeping track of the names and mailing addresses of the stockholders in a giant corporation is no easy task. The photo shows the files of stockholders in one of America's great corporations.**

To control a corporation, it is not necessary to own a majority of the stock; from 10 percent to 20 percent of the voting stock may be adequate for "working control." The possibility of such minority control may result, first of all, from the fact that some of the stock may not have the right to vote. Often preferred stock is without the right to vote. In the past, corporations were permitted to issue "Class A" and "Class B" common stock, with one class denied voting rights (usually Class A). Thus, the table on page 300 reveals that if the largest stockholder in Ford Motors had sold all his nonvoting Class A common stock (over 3

million shares outstanding in 1938), he could still have controlled the company through ownership of more than half of the voting common stock.

A second factor which makes minority control possible is that most of the people who buy corporate stocks have no intention of sharing in the control of the corporation. Most stockholders do not attend stockholders' meetings. They bought their shares either for investment or speculation. If they are not satisfied, they usually sell the shares they own, rather than attempt to change or reform the policies of the board of directors and officers. The larger the number of voting shares outstanding and the more widely they are dispersed, the smaller becomes the proportion needed in order to be the largest stockholder (or group of stockholders) and to control the corporation. All that is needed to elect the board of directors is a majority of the votes cast, rather than a majority of all the voting shares in the hands of stockholders.

A third way in which minority control becomes possible is through the proxy machinery, which has been developed to make it possible for "absentee owners" to vote. The number eligible to vote is so large as to make it impossible for all to meet; furthermore, the meeting place is often a long distance from the homes of many stockholders. Therefore, along with the notice of the stockholders' meeting goes a form by which a stockholder may delegate to another person the right to cast his vote. This document, transferring the stockholder's voting rights, is called a *proxy*. The management, already in office, chooses a proxy committee to cast the votes that are returned by stockholder proxies. The average stockholder deposits his dividend check in the bank, and his notice of meeting and proxy form in the wastebasket. If he does send a proxy back, it will be voted by those who are already in control; if he does not send it back, it reduces the total number of votes, and makes the management's votes a greater percentage of the total. The failure of many stockholders to vote independently, coupled with the failure of many other stockholders to vote at all, makes it easy for a minority group to maintain control. For these reasons, it is clear that the 27-percent stock ownership in General Motors could be enough to maintain control.[4] In such cases there is control of corporate policy, although majority ownership is lacking.

It will be noted in the table, that in several corporations, including the American Telephone and Telegraph Company, and the Pennsylvania Railroad, the largest stockholding was a tiny proportion, under 1 percent. In such corporations the source of control is not the ownership

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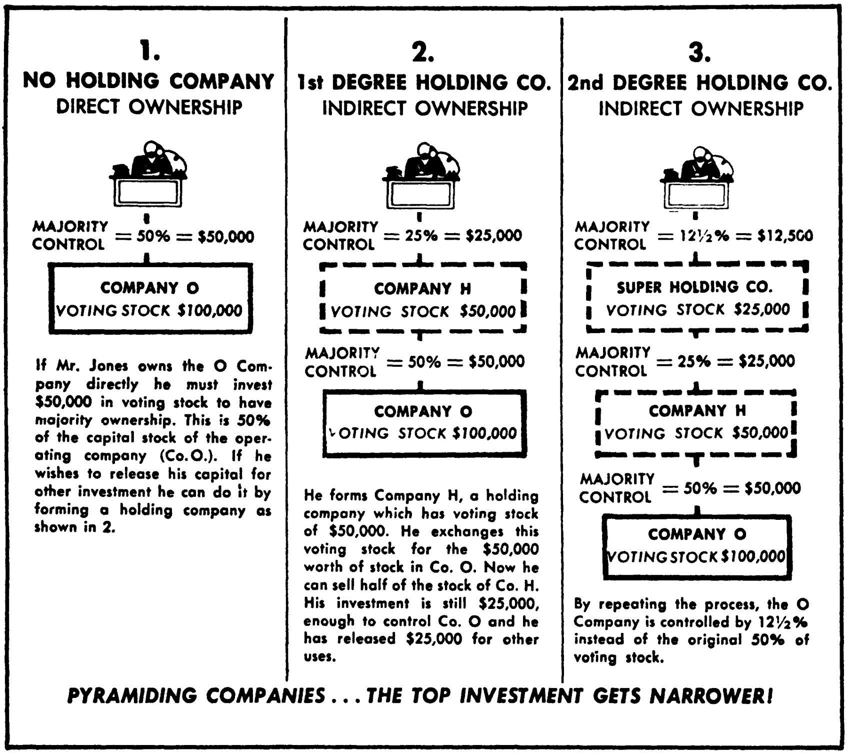
[4] *Op. cit.*, p. 1490.

of voting shares; management is able to obtain and continue control through the use of the proxy machinery. Should a dispute arise between stockholders and management, the management has the advantage of easy access to the names and addresses of the stockholders and can have the corporation pay the expenses of advertising and of circularizing the stockholders for proxies. The "outsider"—the stockholder who opposes the policies of the management—finds it difficult and expensive




to collect proxies for a vote against the management. The proxy battle waged by Rockefeller against the management of Standard Oil of Indiana, in 1929, is said to have cost him $300,000. But such contests are rare. Thus, management tends to remain in control indefinitely. The expectation that in an organization with thousands of owners there would be electioneering, parties, changes in office, and other earmarks of political campaigning is not fulfilled. Control is exceedingly stable.

This type of control, where there is not even a substantial minority block of voting stock, is sometimes referred to as "management control." It becomes more usual as the size of a corporation grows and stock dispersion increases.

### Control Through a Holding Company

Minority control of a large corporation can be furthered through the use of a holding company. This device, which was explained in the previous lesson, has been common in the transportation industries and in other *public utilities* (see p. 327).

From the point of view of control, a great advantage of the holding company is the fact that it reduces the amount of capital which the interests in control must invest in order to maintain control. For example: In the diagram opposite, Jones must invest $50,000 in voting stock of Company O if he wishes to own half of its $100,000 of voting stock.[5] Instead, he forms a holding company, the H Company, and turns over to it the $50,000 of stock in Company O, taking in return $50,000 worth of voting stock in the holding company. He needs to keep only half of that, or $25,000 worth, to guarantee control of the holding company. He can disperse the remaining $25,000 worth of stock to outside buyers; and, with the 50 percent he keeps, he has complete control of Company O. Thus, with $25,000 invested, he controls the same value of assets in Company O as $50,000 did before. Creating holding companies connecting the controlling interests with the operating companies is called *pyramiding*. This process reduces the investment needed to control a corporation.

### Implications of Corporate Control

Investigations during the 1930's revealed that some officers and directors of large corporations had enriched themselves at the expense of the stockholders whom they represented. There were instances in which they had voted themselves huge salaries and bonuses. Sometimes they had arranged, on behalf of corporations in which they had minority control, contracts which would be highly profitable to other corporations in which they owned most of the stock. Some of them had manipulated the prices of stocks in corporations they controlled, so that they were able to sell their own holdings at high prices, or buy the stocks at bargain prices. The exposure of such actions forced the American public to realize the growing importance of the power in the hands of corporate management.

The question has been raised whether the directors of a large corporation stand in somewhat the same position with respect to the corporation as do the elected officials to the public. Do they hold virtually

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[5] Actually, to assure control, he would need $50,100 worth, if shares are $100 each, or just over 50 percent of the voting stock. The round number of 50 percent is used here to simplify the example. It will be remembered that if the stock is dispersed, or if there is nonvoting stock, a much smaller percentage than 50 percent of the total stock issue might be adequate.

a public, rather than a private, trust? This becomes a problem because large corporations have thousands of owners, who may not be in a position to participate actively in the management of these corporations.

In an effort to solve this problem, the federal government enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. These laws established regulation by the Securities and Exchange Commission of securities issues, corporation reports, proxies, stock-exchange dealings, and many other phases of the relations between corporation managements and stockholders.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

closed corporation
control by majority ownership
control by minority ownership
proxy
pyramiding

II QUESTIONS AND PROBLEMS

1) Explain the difference between "control" and "management" of a corporation.
2) Explain how control is exercised where: (a) there is a closed corporation; (b) there is majority control; (c) there is minority control; (d) there is management control.
3) Businessmen may serve as directors of large corporations in which they own no stock at all. What may make them willing to do so?
4) How may it be possible for one-third of the voting shares of a corporation to give its owners complete control of a corporation?
5) (a) What is meant by the "proxy machinery" of a corporation? (b) How does it help to make control by management possible?
6) "The real reason for the divorce of ownership and management in the giant corporation is that the stockholder has abdicated, has become investor rather than enterpriser." Explain.
7) (a) Explain the advantage of indirect control through a holding company. (b) What are the possible dangers in control through holding companies?
8) The large number of stockholders in American corporations like U.S. Steel, Pennsylvania Railroad, and American Telephone and Telegraph Co., has been pointed to as evidence of the existence of democratic control of American industry. Give arguments for and against this theory.
9) "Perhaps society itself is at fault in not having provided the corporate manager with something other than a financial reward. . . . Perhaps we need an Industrial Legion of Honor with a ribbon for the socially sensitive manager to wear on his chest." (*Fortune Magazine*, June 1933, p. 47, "U.S. Corporate Management.") What is there about the job of the corporate manager which makes it desirable that he be "socially sensitive?"

10) (a) Explain this statement: "The giant corporation is characterized by absentee ownership." (b) To what extent is this situation inevitable?

III Things To Do

1) Bring to class newspaper reports of meetings of corporate stockholders or directors, or of other aspects of corporate ownership, control, or management.
2) Draw a diagram or cartoon to illustrate the statement, "In a large corporation, ownership is a centrifugal force, and control is a centripetal force."
3) Read and report on *The Modern Corporation and Private Property* by Berle and Means (Macmillan), 1933, Book I, Chapters 1, 4, and 5.

# *LESSON 40* METHODS OF COMPETITION

## The Struggle for Market Advantage

In sports, rules have been introduced to make contests as even and fair as possible. In boxing, a heavyweight will not be matched against a featherweight; football has its penalties for tripping and holding. Competition in business, however, does not have the precisely worked-out rules and regulations that sports have. There is much difference of opinion as to what is fair and unfair in marketing tactics. In the 1930's, for example, the giants of the oil industry complained about price cutting by the small independent operators. In contrast, small retailers have protested the price cutting by large chains and department stores. There has been some attempt to define by law what is unfair competition. In some industries business itself has informally adopted a "code of ethics" to control competitive tactics. Nevertheless, exact definition of unfair competition has still to be achieved. The difficult problem of making competition fair, and still keeping it competitive, remains to be solved.

The accusation of unfair methods of competition comes from varying sources and is wider in interest than just the businesses directly involved. Consumers, too, have a stake in the methods used in the market. If goods are misrepresented, or priced too high, the consumer has reason to cry "Unfair." Labor, too, is affected, if the struggle in the market forces wages down and makes working conditions inferior.

In 1911, a well-known manufacturer of business equipment with almost a complete monopoly in its field was sued on the grounds of monopoly and unfair methods. The following is a partial list of the methods described in the evidence:

(1) Making false statements about the products and the financial condition of competitors

(2) Placing spies in the competitors' employ to learn business secrets and processes

(3) Bribing employees of competitors, railroad companies, and others to get information as to business practices and processes

(4) Persuading customers to break contracts made with competitors

(5) Arranging for employees to injure competitors' machines in use

(6) Making imitations of competitors' products, deliberately inferior, to discredit their products

(7) Threatening lawsuits for patent infringement, which could not have been proved, in order to embarrass and intimidate

(8) Displaying competitors' products in second-hand stores, labeled clearly as "Junk"

Although competition today is not quite so rough, unfair competition is still a factor in modern markets. The Federal Trade Commission, charged with the prevention of unfair methods of competition, lists many cases in each of its annual reports. Some of the most common methods of unfair competition used today are the misbranding of goods, the adulteration of ingredients, and false and misleading advertising; copying or imitating another firm's name, trademarks, or brand names; and falsely destroying the reputation of a firm by spreading rumors as to its credit standing or slandering its products and service. Interference with the ability of competitors to do business by diverting their shipments of supplies or raw materials, conspiring to bid up the prices of the materials they must buy, and using political position or bribing officials are other types of unfair competition with which the Federal Trade Commission has dealt.

Two practices which in recent years have caused much complaint are *tie-in* sales and *exclusive-dealer* contracts. A tie-in sale is a transaction in which the seller requires the buyer to take unwanted goods in order to get wanted merchandise. This is the case if a manufacturer of electrical appliances forces customers to buy his slow-moving radio models in order to get his fast-moving refrigerator models. An exclusive-dealer contract is one in which the seller of a branded product requires merchants who wish to handle his product to agree not to handle competing brands. The producer of a popular brand of gasoline, for example, may insist that service stations handling its product may not sell competing brands of gasoline.

### Price Discrimination and Competition

Large, powerful business firms are often in a position to increase their volume of business by charging what the traffic will bear. This often

takes the form of *price discrimination,* the practice of charging different prices to different customers for the same article at the same time. Thus, chain stores may engage in *local price cutting,* charging less in stores in locations where there is much competition, and more in areas where there is no serious competition. When such discrimination takes place, there will be one set of buyers paying higher prices because the seller has less competition; here the buyers will complain of monopoly. For the other buyers there will be lower prices, because competition is keen; but here the competing sellers will complain of unfair tactics.

The charge of price discrimination has frequently been leveled against the railroads of this country. Such charges were the original reason for the sweeping regulation of railroad rates by the Interstate Commerce Commission. In recent years the charge of discrimination has come particularly from the Southern states, which have claimed that the railroad rates give Northern and Western shippers an unfair advantage over those of the South.

It is established by law (Clayton Act, 1914) that price discrimination is illegal, when the effect is to lessen competition. However, there has been much controversy regarding quantity discounts as a form of price discrimination. The large buyer, such as the chain store or department store, has an advantage over smaller competitors, because of its ability to buy in large quantities. In the first place, the manufacturer is able to save money in shipping, packing, and delivery expenses, and can pass this saving on in the form of lower prices. In the second place, a very large order has a substantial effect on the volume which he can manufacture, and therefore helps to reduce his unit cost of production. The result is that large buyers are able to get goods at lower prices than small buyers are able to get them, and are often able to undersell the smaller competitors. Is it unfair for large buyers to be given quantity discounts? Small dealers complain that they cannot compete on this basis and that the effect is to create a monopoly. On the other hand, the large buyers point out that to deny them the right to the discounts would be unfair to the consumer and to the manufacturer who finds the business profitable and who is by virtue of large orders able to effect savings in cost. It has been established by law (Robinson-Patman Act, 1936) that quantity discounts are legal only where the seller can prove that lower costs result from the large quantity sold.

### Price Cutting as Unfair Competition

Reduction in price has been generally considered as the prime means of competing. Yet the question has been raised as to whether there is a point beyond which price cutting becomes unfair. If the price cut is used as a sledge hammer by a big business to extend and complete its

control of the market, it is usually considered unfair. This is especially true when the price is cut below cost of production, resulting in losses which the big business can absorb better than the small one.

One practice which has been attacked as unfair is that of the *loss leader*. A loss leader is a product sold at an unusually low margin of profit, or even below cost, in order to attract business for other products sold in the same establishment. For years many large department stores sold books, drugs, and popular brands in general, below cost, thus attracting thousands of extra customers who bought other things besides the reduced items. Cut-rate drug stores use the same method, cutting price drastically on well-known brands. This practice has greatly decreased since the passage of the so-called fair trade laws, described later in this lesson.

One difficult problem in connection with price cutting arises when a firm, through greater efficiency, actually has lower costs than its competitors. Is it unfair if this firm lowers prices to the point which, while profitable for itself, cannot be met profitably by its competitors? Buyers would benefit from the reduction of prices. Suppose the low-cost firm eliminates all its competitors and has a monopoly; would this not be contrary to the interests of consumers in the long run? Another difficult question is whether it is unfair for large retail and wholesale companies to produce their own brands, and sell them at lower prices in competition with the nationally advertised brands carried by small retailers.

Checking on the fairness of a price cut, by investigating the cost of production, is not easy; especially when several products are sold by one firm. A refrigerator manufacturer may also make radios. Let us say that he is better known in the refrigerator field, and has considerable brand preference there. He charges most of his overhead to the production of the refrigerator, which he can sell easily at a profitable price, and thus lowers the cost and selling price of the radio. Do his competitors in the radio business have the right to charge him with unfair competition for cutting price on the radio?

There are various viewpoints as to what is unfair price cutting. Every reduction in price may threaten the stability of some business enterprise, and may be regarded by that business enterprise as unfair. In general, the tendency has been to regard as unfair those acts "designed to give a competitor an advantage unrelated to his productive efficiency. . . . [however] in recent years the tendency appears to be toward denouncing as unfair any effort to compete on the basis of price."[1] Especially during the depression of the 1930's, the idea developed, and was expressed in the National Industrial Recovery Act and the fair

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[1] Clair Wilcox, *Competition and Monopoly in American Industry*, TNEC Monograph No. 21, Government Printing Office, 1940, p. 7.

trade laws, that any action which upset the established price structure is unfair in that it tends to create cutthroat competition.

### The National Industry Recovery Act

This was a short-lived law, passed in 1933 and declared unconstitutional in 1935. The National Industrial Recovery Act (NIRA) contained the idea that control of competitive methods was desirable. The basic principle of the NIRA was to organize a system of industrial self-government, with representation for management, labor, and consumers, in the formulation of the rules.

The law provided for the creation of a National Recovery Administration (NRA), with an administrator responsible to the President. Under the supervision of this administrator, each industry was allowed to set up a code authority, a board in which the businessmen, workers, and consumers of that industry were represented. The code authority drew up a *code of fair competition,* which was a set of rules regarding prices, output, hours of business, credit terms, and other trade practices. For the benefit of labor, every code had to establish a minimum wage, limit working hours, and guarantee the right of the workers in the industry to join unions and bargain collectively. Once the code had been approved by the administrator and signed by the President, it had the force of law for all the business firms in the industry. Violations could be punished by fines and imprisonment. The codes were exempted from the antitrust laws.

When, in 1935, the law was declared unconstitutional, it had been in effect too short a time to provide a definite answer to the problem of regulating competition. It did serve to dramatize the failure of competition to adjust the economy rapidly enough in a period of depression, and focused attention on the need for coöperative action. But there was widespread criticism of the NRA codes as having allowed many monopolistic practices.

In recent years, the Federal Trade Commission has encouraged industries to adopt codes of fair practices. These codes, however, are not exempt from the antitrust laws, and therefore cannot permit price fixing or output limitation. Nor do these codes have the force of law. But they have helped to fix standards of fair competition acceptable to the Federal Trade Commission.

### The Fair-Trade Laws

Another step in the direction of limiting competition has been the Miller-Tydings Act, passed in 1937. To deal with the problem of price cutting, many manufacturers had tried to enforce contracts with retailers by which the latter promised not to sell for less than a price fixed by the manufacturer. Many states had passed laws, called *fair-trade*

*laws*, which made it legal for manufacturers to fix the retail prices of their products. Where, however, interstate commerce was involved, these contracts were held to be in restraint of trade, in violation of the federal antitrust laws. The Miller-Tydings Act eliminated that difficulty by providing that, where there was a state law legalizing such contracts, the federal law (the Sherman Antitrust Act) would not prohibit them. Thus it is now legal in most states (in 1949 in all except Missouri, Vermont, and the District of Columbia), to "fair-trade" a manufactured product by contracting with sellers to maintain resale price. Furthermore, it is the practice, in some states, to make a single contract, entered into with a dealer, apply to all dealers, whether or not they have signed a contract to maintain price; this makes the fixed price general.

The chief support for the fair-trade laws has come from the retail and wholesale distributors of branded merchandise, who see in them some assurance that profit margins will not disappear because of cut-throat competition, especially loss-leader selling by cut-rate stores and department or chain stores. Some manufacturers support the laws strongly because they prevent the destruction by the retailer of the brand prestige built up at such great expense by the manufacturer's advertising.

The chief attack on these laws has come from consumers who feel that these laws have had a monopolistic effect by making it easier for prices to be kept at an excessively high level. It is pointed out, too, that the laws virtually make the retailer an agent of the manufacturer of popular brands, since they remove from the retailer the power to adjust prices according to changes in demand. This has made it more difficult for retailers to liquidate inventories at sale prices.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| charging what the traffic will bear | local price cutting |
| code of fair competition | loss leader |
| exclusive-dealer contract | price discrimination |
| fair-trade law | tie-in sale |

### II Questions and Problems

1) How is each of the following related to the problems of regulating competition or monopoly? (a) Federal Trade Commission, (b) misbranding, (c) Interstate Commerce Commission, (d) Clayton Act of 1914, (e) quantity discounts, (f) Robinson-Patman Act, (g) Miller-Tydings Act and related state laws.

2) Discuss the extent to which you agree or disagree with each of the following statements. Give your reasons. (a) There can be no price discrimination unless there is some degree of monopoly power in the hands of the seller. (b) Loss leaders may hurt business but they help consumers. (c) Selling below cost is unfair competition. (d) Restricting the right to grant quantity discounts to large buyers may be fair to small business but is unfair to consumers.
3) Explain how some methods of unfair competition may be considered as "the theft of intangible assets."
4) (a) State and explain three respects in which one seller may have an advantage over a competitor. (b) Show how each of these advantages may be used in such a way that competitors could call it unfair competition.
5) Explain the features of the NIRA which made it a method of "industry self-regulation."
6) In parallel columns list the arguments for and against fair-trade laws, from the point of view of the whole community.
7) Unfair competition has been defined as "a competitive method designed to give a competitor an advantage unrelated to his productive efficiency." (a) Explain. (b) Do you think the definition a good one? Discuss.

III Things To Do
1) Report to the class on one of the following: (a) the name and provisions of the fair-trade law in your state; (b) why the NIRA was declared unconstitutional.
2) Interview your local grocer and druggist. Report on their opinions of fair-trade laws.
3) Interview adults in your family who may remember the excitement that prevailed at the time the NIRA went into effect. Report to the class.
4) Read *Industrial Price Policies* (Public Affairs Pamphlet No. 23, 1938); also *Steel—Problems of a Great Industry* (Public Affairs Pamphlet No. 15, 1937), for examples of pricing methods.
5) Examine a copy of the annual report of the Federal Trade Commission for examples of complaints involving unfair competition.

# *LESSON* 41 THE CONTROVERSY OVER "BIGNESS"

## Criticisms of Big Business

What to do about the growth of big business, or whether we should do anything at all about it, is one of the most controversial of modern problems. Competition, the argument runs, gives the consumer what he

wants—quality, variety, service, and low prices. Monopoly removes the need for worrying about competition, and permits the businessman to establish market policy independent of other businessmen. Evidence indicates that he often produces less than would be produced if competition were actively in effect, and that he charges a higher-than-competitive price. This limits the rise of standards of living.

Mass production results in economies in cost. However, mass production does not necessarily mean monopoly. The question that must be raised is how much of the increase in the size of business, how much of the interlocking and pyramiding, how much of the consolidation and combination, has taken place in order to achieve greater efficiency, and how much for the purpose of lessening competition, or for making a profit from selling securities. Big business, according to this view, has made our economy top-heavy with organizations more concerned with financial dealings than in producing goods and services. Expansion beyond a certain point may mean excessive red tape, inefficiency, and business bureaucracy. Furthermore, even where large size does mean savings in cost, the existence of monopoly enables the business to keep the savings for the owners in the form of profits, rather than to pass them on to consumers in the form of lower prices.

Big business may slow up the introduction of new methods of production. Large corporations have the resources to pay for research, and thus obtain many basic patents for new inventions and processes. But there is lacking the compulsion, which competition provides, to introduce new methods rapidly. The introduction of inventions may mean the scrapping of existing equipment and the need for new investments. The use of new processes and new products may therefore be delayed for years.

So great has become the size of firms in some industries that the field is practically closed to the entry of new business. In agriculture, retailing, the service trades, construction, and some kinds of manufacturing, it is fairly easy to enter into business. In most manufacturing and mining industries, the amount of capital required is beyond the reach of the average businessman. Although our system is still one of free enterprise, in the sense that any individual has the legal right to enter a business, the economic possibilities are shrinking constantly.

Furthermore, it is argued, the concentration of control of business in the hands of giant corporations makes the community at large pay for errors in judgment on the part of the directors and managers of these enterprises. When small businessmen make mistakes, the effects are limited. Should one of our "captains of industry" err with respect to the amount produced, the price charged, or the proportion of earnings

distributed as dividends, the effects would spread from industry to industry and could generate a wave of depression or inflation.

Big business is a political problem, too. It has become the source of some of the main pressure groups in this country, exercising much influence on national and local governments. Giant corporations have been successful in blocking many kinds of government regulation of business. The press and radio are themselves big business, and are supported by the advertising expenditures of big business. Big business maintains expensive lobbies in the national and state capitals to watch over and influence legislation. The Crédit Mobilier and the Teapot Dome scandals are historical examples of the corruption of government by big business. The development of monopoly in industry carries with it the threat of monopoly control of government.

### Arguments for Bigness

The defenders of big business believe that most of the arguments presented against it are based on the false assumption that big business and monopoly are the same thing. But active competition takes place between big businesses, between brands, between substitutes. How is it possible to say that big business spends so much on advertising, without at the same time admitting that big business engages actively in competition?

The record proves, it is pointed out, that the economies of large-scale operations have been passed on to consumers. Compare the price and quality of automobiles, radios, refrigerators, and many other things today with what their price and quality were when industry was characterized by smaller firms. If it is true that business has grown in size and eliminated much competition, it is also true that production has increased and costs have fallen. Whatever theoretical advantage may be pictured for the competition of many small enterprises, the consumer has benefited in a practical way from the growth of big business and mass-production methods.

The argument that monopoly produces tremendous profits at the expense of the consumer overlooks an important fact: a large part of the profits of big business has been reinvested in research, improved plant and equipment, and expansion of operations, making possible better goods and services at lower costs. This progress is furthered by the stable marketing conditions which exist in the large-scale industries. It is in contrast to the slowness of technological progress in many of the highly competitive industries—coal mining, for example.

The record of advance in American technology, the best in the world, contradicts the argument that technological progress is being blocked.

Each year brings engineering advances and new products from the research facilities of big business. Nor has big business prevented radios, television, washing machines, automobiles, and countless other products from becoming cheap enough to become part of the American standard of living. It would be socially wasteful to scrap existing plant and equipment each time a new technique is developed. Is it not more sensible to plan the introduction of new devices in order to reduce the waste of invested funds?

Competition, some observers believe, has not been an unmixed blessing. The gains to consumers from low prices have been offset by the frequent periods of widespread business losses, wage cutting, and unemployment. Competition has also hastened the exhaustion of natural resources. Conservation costs money; competition blocks the expenditure. In the oil industry, competition has resulted in wasting billions of cubic feet of natural gas, flooding oil-bearing sands with water, and making millions of gallons of oil unrecoverable. Control by big business, even monopolistic control, has one advantage: it allows better planning, and resources are thereby conserved.

Despite the growth in big business, small business still exists and will continue to exist. In such fields as retailing, service, home construction, and farming, small business still dominates. Most of our big businesses are in fields where, before the industrial revolution, there was no business at all. How can there be small business where the nature of the process, as in aluminum or steel making or automobile manufacture, requires large capital investment? Opportunity still exists for small business in new fields of service as standards of living and purchasing power grow. In fact, big business creates small businesses; service stations, trucking companies, and radio repair shops are examples of small businesses which depend on the automobile-manufacturing business.

Big business is not destroying free enterprise; on the contrary, the bulwark of private enterprise is big business. Ownership in giant business is widely dispersed among millions of small stockholders; more people than ever before have a private stake in the operation of business enterprise.

The argument that big business controls the government is not founded on fact. Business is not the only group influencing public opinion and legislation. Labor, consumers, farmers, and other groups have their lobbies and act as pressure groups. Their effectiveness is proved by the passage of legislation which they favor and which big business opposes. It is in the nature of democracy for the various economic interests in our society to make their wishes known to their elected representatives; that is part of a system of representative democracy.

### The Variety of Opinions

The differing opinions about big and small business reflect the variety of economic interests in the nation. The average citizen, who works for a wage or salary, is interested in the size of his money income and in what it can buy. His attitude toward big business depends upon what is happening to his real income. During the depression of the 1930's, when prices were low and jobs were hard to find, he accepted with some sympathy the argument that the elimination of cutthroat competition would make it possible to stabilize markets and achieve recovery. In the years following World War II, when prices zoomed to new highs and rises in the cost of living produced hardship, he was more receptive to the argument that monopoly was keeping prices high. Businessmen, too, vary in their opinions according to the changing market situations they face in buying and selling. When they must buy from business giants with monopoly power, or when they face competition from big business, smaller businessmen complain about monopoly. On the other hand, when they are faced with ruinous cutthroat competition, they strive to organize themselves and argue against the excesses of competition. The attitude of the farmer has generally resulted from the fact that he sells in a market which is highly competitive but buys many manufactured articles in markets which are more monopolistic.

Another reason for variety of opinion is that there are different attitudes about how our economic system is, or should be, regulated. In Lesson 35, the manner in which competition acts as a force for equilibrium was explained. Some people believe that any control over prices by private monopoly or by the government is an interference with the automatic regulation which free competition is supposed to provide. Others oppose monopolistic control over prices and production by business, but favor regulation by the government in order to get the advantages of big business without the disadvantages of destroying competition. Some go so far as to advocate government ownership or government monopoly in certain fields, while others denounce government control as a step toward collectivism.

There is clearly no simple answer to the question, "Which is better for all of us, more small business or more big business, more competition or more monopoly?"

## Exercises and Activities

I Dictionary of Economic Terms

| | |
|---|---|
| lobbying | technology |

## II Questions and Problems

1) Copy the following chart form and fill in as many arguments as you can find on both sides of the question.

| *Arguments for Big Business* | *From the Point of View of* | *Arguments Against Big Business* |
|---|---|---|
| | Prices and quality of consumer goods and services | |
| | Amount of production | |
| | Business costs and efficiency | |
| | Technological progress | |
| | Maintaining free enterprise | |
| | Maintaining stable business conditions | |
| | Conservation of resources | |
| | Protecting political democracy | |

2) State and explain three reasons for controversy about the merits or demerits of big business.
3) Explain and give examples to show that the degree of competition or monopoly is related to the conservation of natural resources. (Consult page 396.)
4) Give two reasons for the claim that big business can produce at lower cost than small business. Give one reason for the claim that great size may cause an increase in cost. (Consult Lesson 30.)
5) Do you agree with the statement that "size does not mean monopoly"? Explain. (Consult Lesson 36.)
6) (a) Explain the argument that big business may help avoid depressions. (b) Explain the reasoning of those who hold the opposite point of view. (Consult Lesson 84, especially pages 654–655.)

## III Things To Do

1) This topic lends itself admirably to debate or forum discussions. Arrange for such a discussion in your class. The following are suggested topics: (a) Is big business a threat to the American Way of Life? (b) Should all laws restricting big business growth be repealed? (c) How can we get the best contributions of large-scale business without suffering from its disadvantages? (d) Should chain stores be taxed (as in some states) in order to protect small retailers?
2) Consult a history textbook and report on the following topics: (a) the political influence of big business, (b) the effect of monopoly on the use of resources, (c) the attitude of farmers toward big busi-

ness. (Note: Some of these topics are discussed in later lessons in this book.)

3) Make your own public-opinion poll. Copy the following form and record the number of answers in each column. Ask the reasons for the answers you get. Compare the answers to the questions. Are the answers consistent?

| | *Yes* | *No* | *Don't Know* |
|---|---|---|---|
| Are you in favor of discouraging the growth of big corporations? | | | |
| Do you prefer to shop in a chain store, a department store, or a small independent retail store? | | | |

4) Read *Government Under Pressure* (Public Affairs Pamphlet No. 67, 1942). A summary of TNEC Monograph No. 26, *Economic Power and Political Pressures.* This pamphlet considers the strength and tactics of business, farmers, and labor in seeking to influence government.

# *LESSON* 42 THE ANTITRUST LAWS

## Origins of "Trust-busting"

The traditional attitude in this country has been to oppose the growth of monopolistic businesses. The appearance of monopoly in the American business world, in the latter part of the nineteenth century, had the effect of destroying the very competition whose workings justified a policy of laissez-faire, or noninterference by government. The government therefore had to intervene, in order to reëstablish competition where it had been stifled, and to prevent its disappearance where that was the danger. This attempt by the government to prevent the growth of monopoly and to restore competition where it has disappeared has often been termed *trust-busting;* and antimonopoly laws are often referred to as "antitrust laws." The term is derived from a form of combination used in the 1880's, the trust, which came to symbolize all forms of monopolistic business organization.

The movement for legal control of big business began in the farming states. The farmers, facing depressed prices for farm products after the War Between the States, and feeling the pinch of monopoly tactics in their dealings with the railroads, formed local "granges," organized nationally under the name of the "Patrons of Husbandry." This organization, founded to accomplish farm aims by political action, is also known as the "Granger Movement." The farmers succeeded in getting state legislatures to pass statutes, referred to as "Granger Laws," which at-

tempted to control and regulate big business, particularly the railroads. The right of a state to pass such laws was challenged in the courts. In 1876, in the case of Munn vs. Illinois, the Supreme Court ruled that a law of the State of Illinois, fixing rates for the storage of grain in warehouses, was valid. However, in 1886, in the case of the Wabash Railroad vs. Illinois, it was held that the fixing of railroad rates by a state was not constitutional, since the regulation of interstate commerce is a power of the federal Congress. Hence, the inadequacy of state legislation was made clear, and attention was focused on the need for a federal statute. The growing political power of industry, the increasing concentration in its wealth and economic power, fear of the expanding power of "Wall Street" and of its control over credit, and the rise of organized labor in the cities created political sentiment hostile to big business and favorable to federal action.

### The Interstate Commerce Act of 1887

This law, providing for federal regulation of interstate railroads, is not usually included in the list of antitrust or antimonopoly laws. However, because it deals with monopolistic practices of railroads and was the first law for federal regulation of a big business, it deserves to be so included.

The law forbade practices (such as pooling, rebates, etc.) which reduced competition or discriminated among shippers. It provided for the public posting of railroad rates. The Interstate Commerce Commission was established to administer the law, to press charges of violation in the courts, and in general to regulate the railroads. The act, in setting up a federal commission or administrative agency, set a pattern which has since been followed in many other cases of government regulation.

Through many amendments, through the interpretations of the courts, and through the setting up of administrative procedures, the powers of the Interstate Commerce Commission have been expanded so that express companies, bus and trucking companies, and pipe lines in interstate commerce are also subject to its administration. The companies in these fields are regulated by the Commission with regard to rates, services, and financial operations. (See Lesson 43.)

### The Sherman Antitrust Act of 1890

The Interstate Commerce Act offered no solution for the problem created by the growth of big business in fields other than the railroads. In 1890, the Sherman Antitrust Act was passed to curb monopoly in the business world as a whole.

The Sherman Act declared that "Every contract, combination in the form of trust or otherwise, or conspiracy *in restraint of trade* is hereby declared to be illegal." Business firms were thus forbidden to act in any way which would have the effect of reducing competition. Violators could be punished as criminal offenders by fines and prison terms. In addition, each person suffering loss from monopolistic tactics could claim damages equal to three times his actual losses. It was hoped that this would encourage business rivals to report violations of the law to the Department of Justice, which was given the task of preparing evidence, instituting actions, and prosecuting the cases. Any firm found violating the law could be ordered to refrain from continuing the illegal acts, and combinations in restraint of trade could be ordered dissolved.

The law was so general that its enforcement depended to a large extent upon the interpretation of the law by the courts. Much to the disappointment of the anti-big-business groups, the courts tended to limit the application of the law. Many contracts and combinations which were alleged by the Department of Justice to be illegal restraints of trade were upheld by the courts as legal. Finally, in 1911, the Supreme Court announced the *rule of reason,* to the effect that a restraint of trade was illegal only if it was an unreasonable restraint of trade. This ruling was made in connection with two famous antitrust cases, in which the Standard Oil Company and the American Tobacco Company were declared to be illegal monopolies. The decisions in these two cases seemed to be offset by the establishment of the rule of reason. In later years this rule was used a number of times to block attempts by the government to curb what seemed to be monopolistic combinations and practices, for example, in the steel and shoe-machinery industries. The Supreme Court took the position that bigness was not in itself proof of monopoly. The burden was placed upon the government to convince the courts in each case that the big business was engaged in specific monopolistic actions.

On the other hand, the law was broadly interpreted by the courts to apply to labor unions. In 1895, a strike against the Pullman Company was declared a conspiracy in restraint of trade, and an *injunction,* or court order, was issued commanding the end of the strike. In 1908, in the well-known Danbury Hatters' case, the law was used by hat manufacturers to collect about $300,000 in triple damages from the union.

The indefiniteness of the Sherman Act and the rule of reason, the failure of the law to check the growth of big business and monopoly practices, and the use of the law against labor unions created a demand for improvement of the law. Two events in 1912 stimulated the movement. A Congressional committee, the Pujo Committee, publicized the extent to which big business had grown and the vast amount of inter-

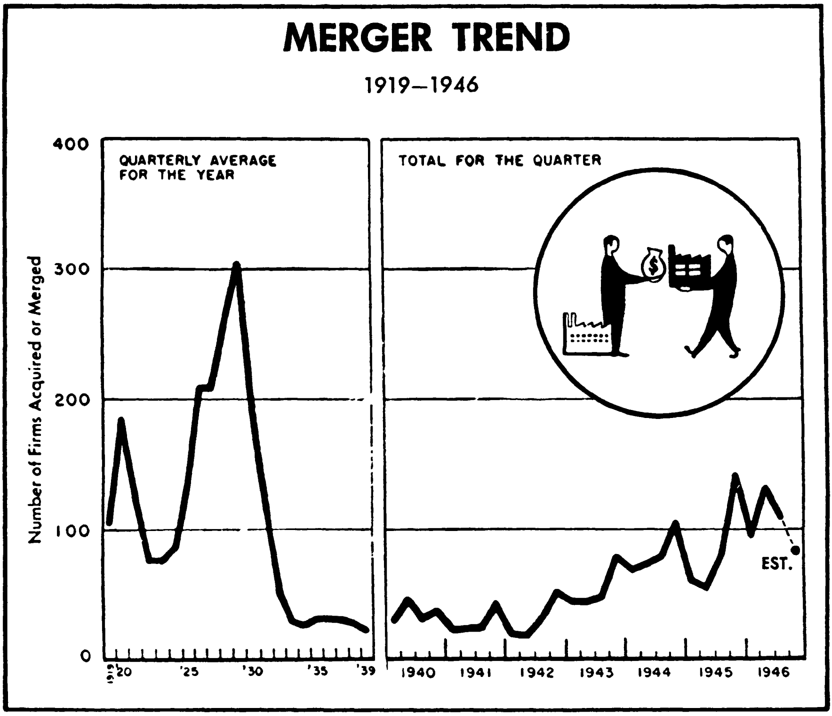
locking with banking firms. At the same time, Woodrow Wilson, whose philosophy of the "New Freedom" included belief in vigorous competition, was elected President. Two years later, in 1914, the Clayton Antitrust Act and the Federal Trade Commission Act were passed.

### The Clayton Antitrust Act of 1914

The chief aim of the Clayton Act was to strengthen the Sherman Act by stating more specifically which actions were illegal. It declared tie-in sales contracts and price discrimination to be illegal when the effect was to lessen competition. It forbade interlocking directorates in banking corporations with more than a specified capital. It attempted to control mergers by forbidding the acquisition of one corporation by another through stock purchases, if the effect was to lessen competition. It declared that farm coöperatives and labor unions were not to be considered as illegal combinations under the Sherman Act. It placed certain limitations on the use of the injunction in labor disputes.

Although the new law was more specific than the Sherman Act, it had so many exceptions and conditions attached to every provision that it provided no real clarification of the problem. Price discrimination was illegal only where the effect would be "to substantially lessen competition or tend to create a monopoly." Quantity discounts, as a form of price discrimination, were exempted; it was not until 1936, in the Robinson-Patman Act, that this exemption was narrowed down to cases where the seller could prove an actual saving in cost resulting from the quantity discount offered. The Clayton Act did little to discourage the merger movement, since mergers could be accomplished by the purchase of the assets just as well as by the purchase of stock. The increased number of mergers in the decade following the passage of the law is clearly shown in the graph which follows, at the top of page 323. Moreover, there was no statement to offset the effect of the rule of reason. Thus the reasonableness of a combination could still constitute a defense against charges of monopoly. In general, the requirement that in order to be considered illegal, the specific acts listed must have the effect of "substantially lessening competition" made the law almost as vague as the Sherman Act.

The exemption of labor unions from the Sherman Act did not prevent the courts from continuing to use the antitrust laws against labor. Many judges interpreted the exemption to mean that while the mere fact of organizing a union could no longer be called a conspiracy in restraint of trade, the specific actions of labor unions could be so regarded. The injunction could still be used in labor disputes, where the facts could be interpreted to make out a case of "irreparable damage" to employers if an injunction should be refused.




When expansion increases profit possibilities, mergers have tended to multiply. Note the rise from 1923 to 1930, and again during the 1940's. The Clayton Act of 1914 did not end the merger movement. (Data from TNEC and U.S. Dept. of Commerce; chart from *Business Week*, March 22, 1947)

THE FEDERAL TRADE COMMISSION ACT OF 1914

This law declared that "unfair methods in competition" were illegal, and established a commission to prevent them from occurring. The law did not list any specific examples of unfair competition. Except for the declaration in the Clayton Act that tie-in sales contracts and price discrimination were illegal, it was left for the Federal Trade Commission to determine what was fair and unfair. Although the Commission is an administrative agency and part of the executive branch of government, it acts to a large extent like a court. Thus, for the most part, the Federal Trade Commission hears evidence, calls witnesses, and if it reaches a decision that unfair competition is involved, issues a *cease-and-desist order,* which orders the offender to stop the practices. If the order is not obeyed, the Commission may get a court order; failure to obey then means punishment for contempt of court. A business firm which has received a cease-and-desist order has the right to appeal to the federal courts.

The expectation was that the actions of the FTC would be directed against the monopolistic practices of large businesses. This has not always been the case, for cease-and-desist orders have also been used against small businesses. In recent years the Commission has sought to eliminate some supposedly unfair practices by holding trade-practice conferences among businessmen in an industry, for the purpose of getting these businessmen to adopt voluntary agreements about fair methods of competition.

Responsibility for instituting and carrying on suits against monopolies was left in the hands of the Department of Justice. However, the Federal Trade Commission was given the power to make investigations and to require reports from business firms, and was made an agent of the Justice Department in gathering evidence. Its investigations and reports have been the source of much of our knowledge about business relationships and monopoly practices.

### The Effects of Antitrust Legislation

In 1938, nearly fifty years after the passage of the Sherman Act, Congress established the Temporary National Economic Committee (TNEC), to investigate the effects of "concentration of economic power." This action was an admission by the government that the aims of the antitrust laws had not been realized. Several reasons have been given to explain the limited effectiveness of these laws.

A primary weakness of the antitrust laws, and generally of laws regulating economic activities, is the difficulty of writing a law which is neither too vague nor too specific. When the law is written in general terms, as was the Sherman Act, enforcement has depended upon the interpretation of the law by the courts. The naming of specific practices to be regarded as illegal, as in the Clayton Act, led business firms to work out monopolistic techniques which were not named in the law. (It is interesting to note that similar difficulties arose in the attempt to develop an effective price-control system during World War II.) The effectiveness of such laws depends ultimately on the skill and vigor of the government in enforcing the law, and on the attitude of the public toward the law.

The enforcement of the antitrust laws has varied according to changes in office. The prosecution of antitrust cases is in the hands of the Department of Justice, headed by the Attorney General, a member of the President's cabinet. Much depends, therefore, upon who the Attorney General may be, and particularly upon who the Assistant Attorney General in charge of the antitrust division may be. Much depends also upon the amount of funds made available for the work of the antitrust

division. Not until 1940 did the annual appropriation for antitrust enforcement reach one million dollars. The number of attorneys engaged in antitrust work has never been sufficient.[1]

It has been stated that laws are "a broad sheet of paper whereon judges might freely write." This has undoubtedly been true in the case of the antitrust laws. The broad generalities in the laws made the judicial interpretations often of greater importance than the laws themselves.

Business firms accused of monopoly have had the money with which to hire the best legal talent in the country. Many cases have dragged on for years, so that the decisions come too late to have any important effect. Often, by the time the case has been ended, new monopolistic methods have been worked out to replace the ones complained about. A further difficulty is that antitrust cases often involve complex economic questions which it is difficult to decide on a purely legal basis.

These handicaps to effective antitrust action are reflected in the figures of actual accomplishment. From 1891 to 1940 between 500 and 600 cases were instituted; an average of only 10 to 11 per year. In over 50 of the cases, about 10 percent, the defendant was a labor union. In the 100 cases in which fines were involved, the total was about 3½ million dollars, or an average of only $35,000 per case. In 26 cases—half of them involving labor unions—there were sentences of imprisonment; in no case was the sentence longer than 2 years. In many of the cases civil, rather than criminal, charges have been brought. Often, in civil actions, the accused company agreed, before decision was rendered, to cease its actions, and entered into a "consent decree," which avoided further legal action.

It has been pointed out that, in view of the difficulties, the results of the government's antitrust work have been relatively good. This is especially true if we keep in mind that there has never been general agreement as to how far our antitrust policy should go. Lesson 40 described the National Industrial Recovery Act, which was a temporary modification of the government's official attitude toward reducing competition. The Miller-Tydings Act, amending the Sherman Antitrust Act to permit activities the courts had previously held illegal, was another evidence of attitudes opposing excessive competition. The antitrust laws, however, have become a part of the American way of life, a symbol of our desire to preserve this country as a land of free enterprise and opportunity for all.

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[1] Walton Hamilton and Irene Till, *Antitrust in Action,* TNEC Monograph No. 16, Government Printing Office, 1941, pp. 23–26, and Appendices, p. 121 ff.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| cease-and-desist order | restraint of trade |
| injunction | rule of reason |
| laissez-faire | trustbusting |

### II Questions and Problems

1) Identify the connection of each of the following with the antitrust movement: (a) Wabash R.R. vs. Illinois, (b) Munn vs. Illinois, (c) Granger Movement, (d) Interstate Commerce Act, (e) U.S. Steel case, (f) Standard Oil case, (g) Danbury Hatters' Case, (h) the New Freedom, (i) Department of Justice, (j) TNEC, (k) consent decree, (l) trade-practice conferences, (m) administrative agency.
2) (a) List the chief antitrust acts. (b) What was their general aim?
3) (a) Why were the farmers most active in demanding antitrust legislation? (b) Why was state legislation unable to meet the problem?
4) Explain how the decisions in Munn vs. Illinois and Wabash R.R. vs. Illinois were related to the passage of the Interstate Commerce Act.
5) (a) How did the provisions and procedures under the Interstate Commerce Act of 1887 differ from those of the Sherman Antitrust Act of 1890? (b) What justification is there for saying that the Interstate Commerce Act was an anti-monopoly law?
6) (a) State the provisions of the Sherman Antitrust Act. (b) Which features of the law made it difficult for it to be effective?
7) (a) What new features did the Clayton Antitrust Act add to the Sherman Act? (b) In what way did these additions attempt to meet the criticisms of the Sherman Act?
8) (a) How did the Federal Trade Commission Act strengthen the antitrust legislation? (b) How does the work of the Federal Trade Commission differ from that of the Interstate Commerce Commission?
9) The question has been debated as to whether the weakness of the antitrust acts was more the result of the law itself or of inadequate enforcement. (a) In what ways was the law itself weak? (b) In what ways was enforcement inadequate?
10) Some have argued that no antitrust law and no enforcement could be effective because big business was a necessary result of modern economic conditions. Discuss this point of view, giving arguments on both sides.
11) The graph in this lesson aims at showing that the Clayton Act did not prevent the growth of mergers. (a) Explain how the graph proves this. (b) Why did the merger movement grow?

### III Things To Do

1) Use your history textbook to prepare a report to the class on one of the following: (a) the Granger Movement, (b) Wilson's New Free-

dom, (c) the Role of Theodore Roosevelt in trustbusting, (d) legislation expanding the powers of the Interstate Commerce Commission, (e) the Wheeler-Lea Act and the Federal Trade Commission, (f) the Work of Thurman Arnold and Wendell Berge as trustbusters, (g) labor unions and the antitrust laws.

2) Read

(a) The references at the end of Lesson 36.

(b) *Cartels, Challenge to a Free World,* by Wendell Berge (Public Affairs Press, 1944).

# *LESSON* 43 PUBLIC UTILITIES

## THE MEANING OF "PUBLIC UTILITY"

When there is an interruption in the work of the railroads, we are suddenly and dramatically reminded of the extent to which the public needs transportation services. There are many examples of industries producing goods and services which are vital and indispensable to public health and comfort. Some of these industries have been legally declared to be *affected with a public interest;* that is, they have been decreed to be so vital to the public welfare, that they are subjected to a greater than usual degree of government regulation. We call such an industry or firm a *public utility.* Examples of public utilities are the industries supplying gas, electricity, communications services (telegraph, telephone, radio broadcasting, television), water, and transportation services (railroads, buses, trucks, internal waterways, pipe lines, air lines).

Not all industries producing vital goods or services are classified as public utilities. For example, it can be argued that milk is more important to the nation's health than oil pipe lines. Yet the latter are a public utility, while milk production is not. More economic suffering and inconvenience may be caused by coal strikes than by telephone strikes. However, the coal industry is not a public utility, while telephone service is. We leave to determination by our legislative bodies whether or not an industry is officially defined as affected with a public interest and is therefore a public utility. Whatever individuals may think, and no matter how excellent the reasoning may be, it is only when those individuals can prevail upon their legislatures to declare an industry to be a public utility, that it may become so. As a matter of fact, the courts have often had the last word on the question. In some cases the courts have overruled the attempt by a legislature to declare a particular in-

dustry a public utility. The reason given by a court has been that it was not convinced that the danger to the public welfare was great enough to justify placing the industry under public regulation. In such cases, the courts have held, public regulation would confiscate private property without due process of law, in violation of the Fifth and Fourteenth Amendments to the federal Constitution.

Public utilities are subject to a particular kind or pattern of regulation, which will be described later. It is possible, however, for an industry to be regulated by the government without being declared a public utility. The bituminous coal industry, for example, was regulated by the industry through its own National Bituminous Coal Commission, in order to avoid cutthroat competition. This it was permitted to do by the Guffey-Snyder Act. The milk industry is regulated in many ways by the states in order to protect public health. All industries, in fact, are regulated in a variety of ways. In the case of public utilities, however, the regulation is more far-reaching and more directly in the public interest.

### Natural Monopoly

Since many vital industries have not been declared public utilities, there are clearly other factors than vital importance which must be considered. One factor is that in some industries public assistance is needed to get the industry started and to enable it to operate. To start a railroad, canal, pipe line, telephone company, or similar business, it is necessary to lay tracks, pipes, or wires, and to use public or private land, which is not the property of the business firm. Such a privilege is called a *right of way*. Businesses cannot get the rights of way they need without assistance from the government. Sometimes the need for enterprises of this kind is so great and the capital requirements so heavy, that the government will assist with financial aid or land grants. The railroads, for example, received millions of acres of land from the public domain; and the development of air lines has been partly financed through *subsidies,* that is; money payments. Thus the relations of such businesses and government are close from their beginning and government supervision of operations may be a consequence.

More important is the fact that in some industries it is to the advantage of the public to have monopoly. Two or more telephone companies, trolley lines, or power companies in the same area would make for public inconvenience. The duplication of wires, pipes, street openings, and tracks and trolleys could easily become a tremendous nuisance to the public. When two telephone companies operated in Philadelphia, each subscriber had to have two telephones to get complete service. In such cases the public convenience makes monopoly desirable.

Duplication of facilities in some fields would bring a more serious

consequence than inconvenience: it would mean greater cost. The capital investment in the power, transportation, and communication industries is very great. Overhead costs tend to make up a very large proportion of total costs. Therefore, the greater the number of customers, the lower the cost per customer becomes. If only one company is permitted to serve an area, it is possible for it to spread its overhead costs very thin and to give the benefit of lower cost per unit. If several companies, duplicating plant facilities, were to compete, the total overhead cost would be greater in proportion to the number of customers served. Competition would tend to increase, not decrease, the cost of these services. Monopoly is therefore desirable in these industries, provided there is regulation by the government to protect the public.

For the reasons mentioned, such industries are referred to as *natural monopolies*. By a natural monopoly we mean an industry in which monopoly is clearly beneficial and competition clearly wasteful, because of the nature of the product and the production processes involved.[1] A natural monopoly becomes a legal monopoly when the government grants a *franchise;* this is a grant by the government of exclusive privileges of operation within a specified area, provided that the firm supplies specified services. Thus, the franchise itself may require certain minimum standards of service. In addition, the firm may be subject to the specific laws of the state, federal government, or local community regulating public utilities. Thus, a railroad crossing state borders, in addition to being regulated by the Interstate Commerce Commission, is subject to the obligations set forth under franchises, granted by the states and municipalities, pertaining to terminals and rights of way.

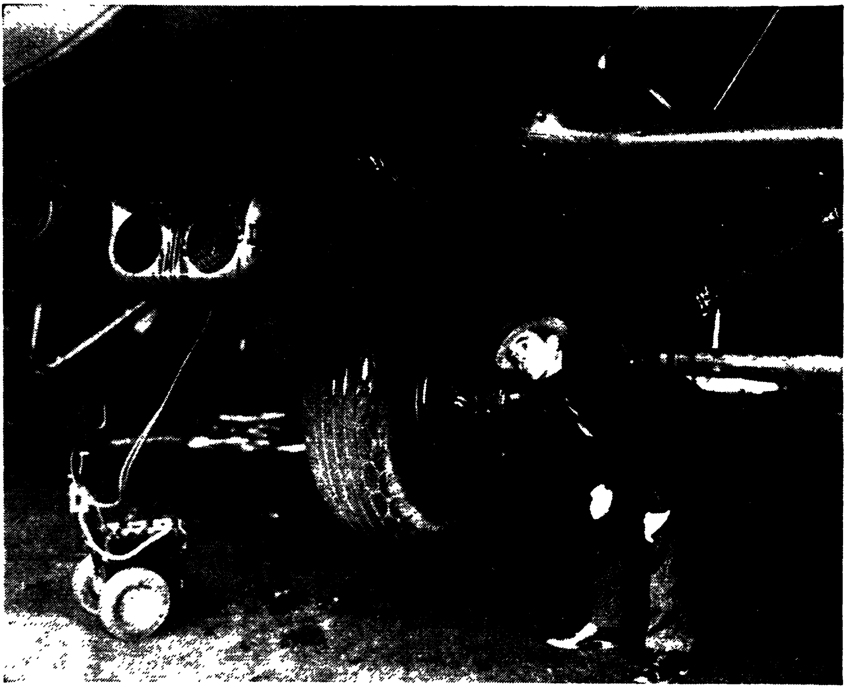
Although the existence of natural monopoly may be an overpowering factor in declaring industries to be public utilities, not all public utilities are monopolies. Thus there is competition within each type of transportation—railroads, air lines, trucks—and the various means of transportation compete with each other. Were the milk industry to be declared a public utility, it would not necessarily mean that the field of milk production and distribution in a given city would have to be turned over to a single, monopolistic company. It would mean that having been declared "to be affected with a public interest," the industry would be subjected to government regulation as a public utility.

### The Pattern of Public-Utility Regulation

The laws creating and regulating public utilities, although varying in detail, follow a similar pattern. Generally a commission—a board consisting of a few men appointed by the President or by the governor of the state—is created to control the industry within the provisions of

[1] *Natural monopoly* is also used to describe monopoly based on possession of scarce natural resources, as in the cases of sulphur and diamonds.

the laws. Thus, in the federal government, the Interstate Commerce Commission controls interstate railroads, pipe lines, bus and trucking firms, and barges and ships on internal waterways. The Federal Communications Commission regulates interstate telephone, telegraph, radio, and television companies. The Federal Power Commission regulates electric-power companies which transmit electricity across state lines, and controls power sites on rivers under federal control. The Civil Aeronautics Administration controls air transportation. In the states



*CAA photo*

**The Civil Aeronautics Administration is a federal commission regulating interstate air transportation. An aviation safety agent is shown in his routine task of inspecting aircraft for airworthiness.**

the regulation of all intrastate public utilities is usually combined under one commission usually called a *public-service commission.*

The degree of control that a commission may exercise is set forth in the law which it administers, and the law is interpreted by the courts in deciding controversies which reach the courts. Generally, the scope of regulation by a commission over a public utility includes the following:

1. To determine what are fair and reasonable rates for the different types of service offered, consistent with fair and reasonable profits as defined by the law.
2. To specify uniform methods of keeping books and figuring costs as a means of determining what are reasonable rates and profits.
3. To specify uniform methods of computing the amounts invested in the business, since "reasonable profits" are related to investment.
4. To supervise the quality of the service rendered and to set minimum standards of performance.
5. To approve or disapprove plans for raising funds through the sale of stocks or bonds.

### Problems of Commission Control

For a number of reasons, control of public utilities by commissions has been difficult. One problem has been to decide what a reasonable profit is for a public utility. When times are good for business in general, profits of 6 percent on investment may be unreasonably low; when times are bad, profits of 6 percent may seem unreasonably high. It is also hard to figure the investment on which the reasonable rate of profit will be allowed. To determine whether a firm is making a reasonable rate of profit, the amount of profit has to be compared with the investment (net worth). Since the net worth is the difference between assets and outside liabilities (see Lesson 27), it is necessary to have precise measurement of the value of the assets. In the case of many public utilities, this measurement is difficult because a large proportion of the assets are fixed assets—plant and equipment. Should these assets be considered to be worth what they were when purchased (*original cost*), or should they be counted as worth what it would cost to construct them at the time the rates are being figured (*reproduction cost*)? If they are to be figured at the original cost, how much should be charged for depreciation? A further complication arises from the fact that cost per unit varies with changes of output. Since there are different classifications of service, with varying amounts of competition in each, how shall rates be differentiated for these classifications? For example, what rates shall be charged to industrial consumers of electricity, and what rates to home users? On the railroads, what rates should be charged for freight from each coal field, since equal rates for all fields would give an advantage to producers nearer the market?

These are extremely complicated questions with far-reaching economic effects. The commissions, in grappling with these problems, are subject to pressures from consumers who want low rates and high-quality services, from utility companies who wish to select a price policy that will yield a high profit on investment, and from other industries whose own costs and competitive situation are affected by

what they pay for transportation, power, communication, and other goods and services produced by utility companies.

Another difficulty in commission control arises from the fact that the government has not paid commissioners and commission experts as much as the utility companies have been able to pay their own experts. The result has been that many of the best legal and business talents have been attracted to private rather than to public employment. It is a common occurrence for attorneys and accountants employed by regulatory commissions to leave, after a period of apprenticeship in public employment, for the better-paying positions offered by public-utility corporations.

Regulation of utilities by public commissions is a slow process because the decisions of the commissions are subject to review by the courts. Cases involving rate changes have often lasted many months, even several years. The courts have been cautious in granting to public-service commissions powers which the commissions claimed were needed to make public-utility regulation genuinely effective. Commission decisions have often been set aside by the courts on the grounds that they constituted confiscation of property without due process of law.

The conflict in powers of regulation between state and federal government has also hindered public-utility regulation. The control over interstate commerce is a power of the federal government; the control over intrastate commerce is a power reserved to the states. Thus there has been an overlapping of federal and state control, especially with regard to power companies. The policies of the federal and state bodies have not always fitted together.

Financial control of public-utility corporations, organized in complicated holding-company structures throughout the nation, was particularly difficult under state laws. A federal law, the Wheeler-Rayburn Act of 1935 (also called the Public Utility Holding Company Act) attempted to remedy this situation by prohibiting holding companies in interstate commerce from being too remotely connected with their operating companies.

Despite all these difficulties, however, there has been a gradual development of experience and law pertaining to the work of commissions regulating public utilities. There seems to be little doubt that commission control over rates and profits of public-utility corporations has been reasonably effective.

### The Publicly Owned "Yardstick"

As has already been explained, the major problem faced by commissions in determining rates is the difficulty of agreeing with the public

utility as to the value of the investment and as to costs of production, or net worth. One method proposed to meet this problem, in the field of electric power and light particularly, is that of the publicly owned *yardstick plant.* A yardstick plant is a plant operated by the government in order to get a measuring rod by which to judge costs in the plants of a public utility. Opponents maintain that the tax advantage of the publicly owned plant would make it an unfair standard for private costs. Its advocates claim that it is possible to allow in the government figures for the taxes which the private companies have to pay.

## Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | |
|---|---|
| franchise | public service commission |
| legal monopoly | public utility |
| natural monopoly | right of way |
| yardstick | |

II QUESTIONS AND PROBLEMS

1) Identify the connection of each of the following with public utilities: (a) affected with a public interest, (b) Interstate Commerce Commission, (c) Federal Power Commission, (d) Federal Communications Commission, (e) reasonable profits, (f) original and reproduction costs, (g) Public Utility Holding Company Act of 1935 (Wheeler-Rayburn Act).
2) Explain why it is considered desirable to define certain industries as "public utilities."
3) List and explain briefly three chief functions of a public-service commission regulating a public utility.
4) State briefly and explain three difficulties faced by commissions in regulating public utilities in the public interest.
5) (a) What is meant by a "yardstick"? (b) How might the TVA be used as a yardstick for electric power rates? (See page 337.)
6) From what you have learned about public utilities, would you judge that their stocks and bonds would be more or less secure for investment than the stocks and bonds of ordinary corporations? Explain.
7) What are the chief difficulties in fixing a reasonable profit and reasonable rates to be charged by utility companies?
8) (a) List the public utility companies which serve your home (or community). (b) Bring in bills received from these companies. What evidence is there on the bill that the industry is regulated?
9) Some trucks carry license plates labeled "ICC" and "PSC" as well as the plates of the regular commercial vehicles. Explain.

III THINGS TO DO

1) Using an American history textbook as reference, report on one of the following: (a) Legislation developing the powers of the Interstate Commerce Commission; (b) The role of the Granger Movement in bringing about public utility regulation; (c) The controversy over the establishment of the TVA.
2) Write to the Public Service Commission of your state, asking for literature describing its activities. Report to the class.
3) Interview the manager of a local public utility about the current effects of government regulation. To what extent would a consumer's organization agree with the opinions expressed?
4) Read and report on parts of *Public Control of Business* by Keezer and May.

# LESSON 44 GOVERNMENT AND BUSINESS

## THE DILEMMA FACING THE AMERICAN PUBLIC

The American people have found it difficult to decide their attitude toward the growth of big business. They wonder, first of all, whether this growth is inevitable or whether it can be checked. If it can be checked, should it be? There is widespread concern about the concentration of so much power in the hands of giant, monopolistic corporations, also about the disastrous effects which can result from unrestricted competition. Yet the attempt to control the two extremes, unrestricted monopoly and unrestricted competition, introduces another factor which upsets the traditions of the American business world: government control. There seems to be a triple threat—too much monopoly, too much competition, too much government control. How to avoid all of these threats is the problem.

The problems of competition and monopoly, and some of the methods used to meet these problems, have already been described in previous lessons. The approaches which have already been taken and which may be taken in the future, can be summarized under five headings: (1) aiding small business; (2) encouraging self-regulation by industry; (3) checking the growth of monopoly; (4) extending the definition of "public utility" to include more industries; (5) increasing government ownership and operation.

## AIDING SMALL BUSINESS

The government has striven to offset the strength of big business by offering special assistance to small business. The Department of Commerce of the federal government and similar state agencies have given

education and advice to small businessmen in the form of pamphlets explaining how to organize and operate small businesses, and reports on those fields in which the opportunities for small business are greatest. Small businessmen have also been given some preferential treatment in the taxes on business incomes. They have also been aided, in some states, by taxes on chain stores. Such laws as the Robinson-Patman Act and the Miller-Tydings Act have made it more difficult for large businesses to undersell the small ones—at least, that has been the intention of such laws. Steps have been taken toward setting up for small businessmen a special system of government credit, which would provide them with capital, just as has already been done for the farmers of this country. An indirect way of helping small business may be an improved enforcement of the antitrust laws.

### Encouraging Self-Regulation by Industry

The National Industrial Recovery Act of 1933, described in Lesson 40, was an attempt to set up a nation-wide system of industrial codes of fair competition. Each industry was to operate under a code, approved by the government, which would strike a balance between the extremes of competition and monopoly. The system lasted only two years and was in many ways a failure. Moreover, since the 1930's, the Federal Trade Commission has supervised the establishment of codes of fair practices in many industries, as a way of eliminating unfair methods of competition. These codes are based on the theory that the enforcement of fair practices will make it easier for small businesses to survive.

### Checking the Growth of Monopoly

In 1938, at the request of President Roosevelt, a joint committee of Congress and the executive branch of the government was created to study "the concentration of economic power in American industry and the effect of that concentration upon the decline of competition." For more than two years this committee, the Temporary National Economic Committee (TNEC), made studies and held hearings regarding the workings of the whole economic system. The result was more than 20,000 pages of testimony by leaders of industry, labor, consumer organizations, economists, and other technical experts. There were over 3000 technical exhibits and 43 monographs, or special studies, on particular subjects prepared for the use of the committee. The combination of hearings and monographs made available a tremendous library of economic data and opinions.

The recommendations of the Committee dealt with specific amendments required to make antitrust enforcement more effective. The maintenance of competition and the need for antitrust legislation was set forth as a goal. "It is generally agreed . . . that competition must be

maintained as the principle of our economy, for everyone seems to acknowledge that the alternative to competition is some form of concentrated government authority which might easily destroy democracy. . . . The extended study of the concentration of economic power made by this committee leads inevitably to recommendations to strengthen the antitrust laws. No hope of preventing the increase of evils directly attributable to monopoly is possible, no prospect of enforcing and maintaining a free economic system under democratic auspices is in view, unless our efforts are redoubled to cope with giant corporations of capital which have become so dominant in our economic life."[1]

Specifically, the recommendations urged more liberal financing of antitrust activities; requiring trade associations to register; repeal of the Miller-Tydings Act and of fair-trade laws; strengthening the provisions of the Clayton Act to discourage mergers; outlawing holding companies as a device for combination; revising patent procedures to make monopoly through patents less likely; and uniform federal chartering of corporations.

The Committee did a tremendous job in gathering and evaluating data, but its recommendations were not drastically different from those that had been made before. The coming of war with its urgent problems of production, and the postwar problems of reconversion put the report's recommendations temporarily out of public mind.

### Extending the Definition of "Public Utility"

Lesson 43 explained the nature of regulation existing in industries affected with a public interest. It has been suggested that the definition of "public utility" be applied to any industry of key importance, such as milk or coal or others in which there is either too much competition or too much monopoly. Where there is cutthroat competition, the purpose of regulation would be to eliminate the substandard wage conditions, the unfair tactics, and the price-cutting policies; to stabilize the industry and improve its service to the public, while preserving private ownership and operation. Where the problem is monopoly, the purpose of regulation would be to control rates and services in order to prevent excessive charges to the public. Extending the public utility concept to more and more areas of the economy would obviously mean considerable modification of the free enterprise system.

### Government Ownership and Operation

In recent years there has been a growing tendency, in various parts of the world, to *socialize* industries; that is, to place industries under

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[1] *Final Report and Recommendations of the Temporary National Economic Committee,* March 13, 1941; pp. 25 and 35.

government ownership and operation. In the United States the belief in private enterprise has been too strong to permit a strong trend toward socialization. There have, however, been discussions of the possibility of socializing certain industries because of particular difficulties in those industries. During the 1930's, for example, the railroads were in desperate financial condition because of heavy debt and low earnings, partially as a result of increasing competition from automobiles, trucks, buses, and airplanes. Some people felt, therefore, that the railroads should be socialized and operated as a public service. Similar suggestions were made about the bituminous coal industry, which at that time faced cutthroat competition and substandard working conditions. More recently, when coal production was interrupted by labor troubles, and when steel supplies proved inadequate for the postwar needs of the country, the suggestion was renewed that these key industries be socialized, so that production, price, and labor policies could be publicly determined.

Those who favor nationalization of these industries argue that it need not mean that the entire economic system must be socialized. They point out that there has always been some government ownership and operation. The post office and postal-savings banks have been run by the government without preventing private express companies and savings banks from operating. The federal government for years has administered our resources of helium, used as a gas in dirigibles. It has similarly created a complete government monopoly of atomic energy and atomic-materials production. During World War II it operated many plants producing war materials, and during World War I it temporarily took over operation of the nation's railroads. In the Tennessee Valley the government operates a vast project in regional planning, soil conservation, reforestation, transportation improvement, and flood control. Similarly, the government carries on business as a large-scale producer of electric power at the Hoover Dam, Grand Coulee, Bonneville, and others. Thus, it is pointed out, government ownership has been resorted to on a limited basis to solve particular problems, without turning our system into one of complete socialism.

The ownership of enterprises by local and state governments is also common. Toll roads, bridges, and tunnels operated by states are common. The Holland Tunnel, George Washington Bridge, and other income-producing facilities of the Port of New York are operated by a specially chartered corporation, the Port of New York Authority. An *authority* is a corporation which conducts an enterprise on behalf of a government. Many municipalities own and control their own power plants, subway and bus lines, and other such facilities. Housing projects are also owned and operated by cities, states, and the federal government.

Opponents of extending government ownership point out that government ownership of part of an industry would soon lead to the disappearance of all private industry in that part of the economy. So interrelated are our major industries that even those industries remaining in private hands would be at the mercy of government industry and power. Gradually the area of government ownership would be extended until the entire economy would become government-dominated; socialism and collectivism, rather than free enterprise and individualism, would become the order. The legal institutions of property and freedom of contract would lose all meaning. Political life, as well as economic life, would become controlled and planned. The incentives of private profit would be removed, progress would be slowed down, and bureaucratic government officials, holding position for political reasons rather than for reasons of efficiency, would make production inefficient and static. If private monopoly is bad, the opponents argue, public monopoly would be worse.

More recently the problem has been summarized by a government agency, the Council of Economic Advisers, in these words:

> In a stable and expanding economy, there is room both for well-conducted big business (with its unique facilities for scientific and developmental experimentation) and for small business with its display of individualism and self-reliance. Small business should be protected from any predatory practices by its larger neighbors, and all business should be protected against unfair competitive practices by units of any size. Yet the truth at least in part is that small business is threatened not primarily by big business but rather by big instabilities in the economy. When the economy attains full prosperity and is moving upward, small business in general does very well; but when the economy hits the toboggan many small businessmen are ruined not because they are less efficient than big business but because they are weaker and have fewer sustaining resources. An economy that grows steadily, as our economy can, would provide manifold opportunities for small business . . . .
>
> We are still a long way from having completed the necessary rethinking of problems involving business size and practices. Much more work needs to be done. It should proceed in a spirit of fair objectivity toward business both large and small.[2]

## Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

authority socialize

[2] Council of Economic Advisers, *Business and Government*, Fourth Annual Report, December, 1949, pp. 10–11.

## II Questions and Problems

1) Explain what is meant by "the triple threat of too much competition, too much monopoly, too much government control."
2) List and explain in one sentence each of the five "channels of approach" discussed in this lesson.
3) List five means of giving special assistance to small business.
4) State and explain two examples of "self-regulation by industry."
5) (a) Explain the aims of the TNEC investigation. (b) State and explain briefly three of its recommendations. (c) The TNEC was created to study "the concentration of economic power." Why did the investigation look into the organization and functioning of the entire economic system?
6) (a) Explain how the creation of more public utilities might be an approach to preventing both excessive competition and excessive monopoly. (b) List arguments for and against such a proposal.
7) In parallel columns list the advantages and disadvantages of extending government ownership.

## III Things To Do

1) There are many possibilities for good debate or forum topics. Prepare a list of five possible topics. From the topics presented in class select one, and organize a panel or forum discussion.
2) A panel discussion, with five speakers, each taking the task of presenting arguments for one of the approaches discussed in the lesson, may be an interesting and useful review.
3) Read *Economic Roads for American Democracy* by William P. Van Til (McGraw-Hill, 1947), which presents varying approaches to similar problems in interesting dialogue.

# *UNIT* 8

## MONEY, CREDIT, AND THE PRICE LEVEL

*45* MONEY AND CREDIT
*46* THE EFFECTS OF INFLATION AND DEFLATION
*47* MONETARY STANDARDS
*48* THE MONEY ISSUE IN AMERICAN HISTORY
*49* THE FEDERAL RESERVE SYSTEM
*50* GOVERNMENT CONTROL OF CREDIT

# *LESSON* 45 MONEY AND CREDIT

## The Functions of Money

In some parts of the world, trading is still done by the *barter* method, by direct exchange of goods and services for other goods and services. Barter is a cumbersome method of trading. A dairy farmer, for example, has to find people who not only want milk and eggs, but have a surplus of just the things the dairy farmer wants. For this reason, civilized peoples have developed *money systems* for carrying on trade.

Money is whatever is used in a community (1) as a *medium of exchange,* (2) as a *standard of value,* and (3) as a *store of value.*

A medium of exchange is anything which the people of a community generally accept from one another in payment for goods and services. In the early stages of a civilization, money is some commodity which is specially prized by the people of the community: wampum, seashells, cattle, tobacco, iron, silver, or gold.

*Chase National Bank Collection of Moneys of the World, N.Y.*

**The left panel shows the huge stone money of the Island of Yap; the right panel shows some examples of shells and beads used as money.**

As a standard of value, money is the unit of measurement of economic values. We measure length in terms of inches, feet, and yards; and weight in terms of pounds and tons; we have various units of measurement for heat, strength, and other physical characteristics. Our money system enables us to compare the economic exchange values of different things. A $10 hat has twice the exchange value of a $5 pair of shoes.

Because money is a store of value, it can be saved for the future. It is not normally necessary for people to hoard goods for future use. Instead they can accumulate money in the form of cash, bank deposits, insurance, or investments, and then convert these savings into whatever goods and services they may desire at a particular time; they may even leave the savings for the use of future generations.

### Kinds of Money

As civilizations have developed to a higher level, they have turned to metals as the basis of their money system. Metals are more durable than other commodities and can be easily shaped and stamped into coins. In modern times the most widely used metals have been gold and silver, because their relative scarcity and their beauty have given them a high value. For use as coins, gold and silver are more durable and uniform in quality than other metals.[1]

Gold and silver money proved inadequate, however, for the extensive trade of modern times. Money bags filled with gold and silver coins were romantic objects, but they were bulky, heavy, and easily stolen. At every transaction each coin had to be weighed and carefully examined, to make sure that it was fully worth the value that was stamped on it, for counterfeiting and clipping of coins were common. More convenient methods had to be developed for making payments in large amounts and over long distances.

During the 18th and 19th centuries the use of paper money, issued by banks and governments, became widespread in the more advanced parts of the world, especially in North America and Western Europe. To reassure the users of paper money, the governments and banks which issued the paper money made it *convertible*, or *redeemable*. They guaranteed that people could, at any time, exchange the paper money, at the banks or the government treasury, for gold or silver, at the legally fixed prices of these metals. The metal would be given out in the form

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[1] In the United States, gold coins have not been used in ordinary transactions, because of inconvenience. Instead, the government issued *gold certificates*, paper money which represented the various sizes of gold coins, and which could be exchanged for the gold coins at any bank. In 1933, the gold certificates (as well as gold coins) were withdrawn from circulation.

of *specie*—standard coins of gold or silver, or gold or silver *bullion* (refined metal, not made into coins). Sometimes the government encouraged the circulation of the paper money by declaring it to be *legal tender,* that is, money which must be accepted by a creditor when offered by a debtor. Convertible paper money was more convenient than the coins or metals, and commanded the same respect and confidence as the coins and metals—as long as the banks and the government made good on their guarantee.

The coins now used are mainly *subsidiary money,* or *token coins,* that is, coins which have a metallic content below the face value. The silver in a dime, for example, is worth no more than three or four cents. The reason for this practice is that in the eighteenth and nineteenth centuries, coins often disappeared from circulation. All coins then were *standard coins;* that is, coins with a metallic value equal to the face value. If gold and silver became scarce, and the market price of these metals went up, it was profitable to melt the coins and sell the metal. The business world would then lack an adequate amount of money with which to conduct its transactions, especially in retail business. To overcome this difficulty, our government introduced the system of token coins. The coins from the penny to the half-dollar were manufactured with so low a metallic content that there was no further inducement to melt them. Since then we have had an ample supply of small change.

The use of standard coins, such as the gold pieces which were available in this country before 1933, has virtually disappeared from the world. Since World War I, people everywhere have become accustomed to paper money, although gold and silver coins are still hoarded in the rural districts of Europe, Asia, and Africa. In monetary systems today gold and silver are used as *monetary reserves*—supplies of precious metals kept by the government as a guarantee of the soundness of the money system. The world-wide acceptability of American paper money, for example, is based not only on the universal confidence in the American economy, but to some extent also on the twenty-billion-dollar gold reserve which our government has accumulated.

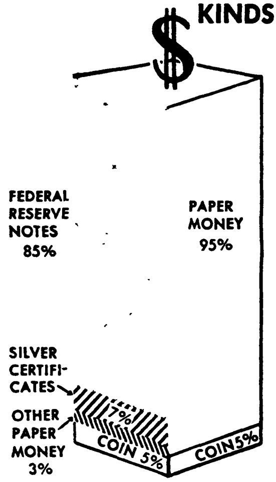
The most efficient method of payment which we have developed is the bank check, which is described in detail in Lesson 26. Checking accounts are often referred to as *deposit money,* or *deposit currency.* When Jones gives Smith a check for $100, Jones is handing $100 of his bank deposit to Smith, in the same way that he might hand over a $100 bill. Making payments with checks puts bank deposits into circulation as part of the money system. There is one important difference, however, between checks and the other kinds of money. Coins and paper money are issued by the government, or by the Federal Reserve Banks under the authority of the federal government, and are

therefore accepted without question by everybody. Checks are acceptable only when the receiver of the check knows enough about the signer of the check to be fully confident that the check is good. Despite this limitation, bank deposits, circulating by means of checks, have become our most important medium of exchange.

### How Money Gets into Circulation

One question often asked is this: How does cash money get into circulation? This question loses its mystery if we remember that money is not created for its own sake, but for use as a medium of exchange.

**KINDS OF MONEY IN CIRCULATION, APRIL, 1947**




| KIND OF MONEY | (millions of dollars) | |
|---|---|---|
| **PAPER MONEY** | | |
| Federal Reserve Notes<br>Denominations—$5, $10, $20 and up to $10,000 | $24 000 | 85% |
| Silver Certificates<br>Denominations—$1, $2, $5, $10 | 2,000 | 7% |
| Other Paper Money<br>Denominations—$2, $5, $10 | 850 | 3% |
| TOTAL | $26,850 | |
| **COINS** | | |
| Subsidiary silver (10-25-50 cents) | $ 875 | |
| Minor coins (1-5 cents) | 325 | |
| Silver dollars | 150 | 5% |
| TOTAL | $ 1,350 | |
| TOTAL MONEY IN CIRCULATION | $28,200 | |

Chart by GRAPHICS INSTITUTE, N. Y.

Almost all of the money in circulation is paper money, of which the largest part is Federal Reserve Notes issued by the twelve Federal Reserve Banks. Gold coins and certificates are not permitted to circulate. Silver certificates, issued by the government, provide lower denominations. (Data from Federal Reserve Board)

Individuals need cash for making purchases, and stores have to keep money in their cash registers for making change. Business firms need cash for payrolls and other payments. This money is secured from the banks. The more business being done in retail stores, and the bigger the payrolls of the business firms in the community, and the more money consumers are spending for various purposes, the larger the amount of money which will be drawn from the banks and kept in circulation. More money, for example, is needed in circulation on Fridays and Saturdays for payrolls and shopping, whereas less money is needed in the early part of the week. The amount of money in circulation in-

creases greatly during the Easter and Christmas seasons, and shrinks immediately after these seasons.

Where do the banks get the money which they pay out to their customers? That depends on the money system of the country. In the United States there are several kinds of money. All coins—gold, silver, copper—are manufactured (minted) by the federal government, and are sold to the banks at their face value. The government also prints paper money known as "silver certificates" in denominations of $1, $2, $5, and $10. These bills are called silver certificates because for each dollar's worth of these certificates, the government keeps in its storehouse a given amount of silver. These silver certificates are also sold to the banks by the government at their face value.

As the chart opposite shows, more than four-fifths of the money used in this country consists of Federal Reserve Notes. These are bills in denominations of $5, $10, $20, and up to $10,000. They are issued by the Federal Reserve Banks, in accordance with the laws of the federal government. When banks need cash for their customers, they make withdrawals from their accounts in the Federal Reserve Banks, and get Federal Reserve Notes and other forms of money.

### Deposits and Credit Creation

The most important kind of medium of exchange in circulation, however, consists of the checks drawn against bank deposits. Most deposits are surplus funds placed in the banks by business firms. But commercial banks can create, as well as accept, deposits. If a commercial bank were to act strictly as a middleman, it could not lend any more than it took in as cash deposits, plus what it had as original capital. That, however, is not the case; a commercial bank is able to "manufacture" credit by granting loans in excess of the cash on hand.

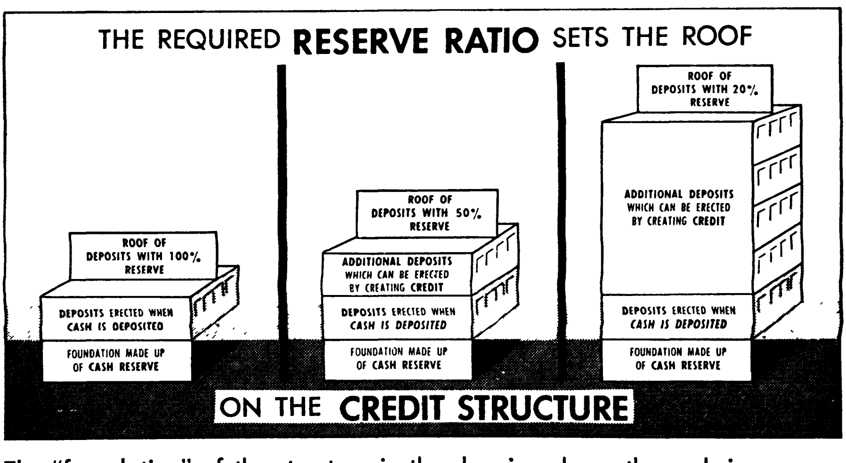
How can a bank risk lending this cash if it may have to repay the depositor at a moment's notice? If there were only one depositor, who made one large deposit, and might withdraw it all at once, lending the money to somebody else would be extremely risky. But there are many depositors, and the banks know from long experience that they will not withdraw all their money at the same time. Ordinarily the withdrawals and deposits balance each other reasonably well. The bank, therefore, needs to keep only part of its cash on hand to meet the demands of its depositors. Experience has shown that, normally, a bank can take care of all depositors' demands with 20 percent, or even less, of its cash on hand. The amount of cash kept on hand to meet liabilities to depositors is called the bank's *cash reserve,* or simply its *reserve.* The percent of cash in relation to deposits is called the *reserve ratio.*

Here is a simple example. A bank has $1000 in cash, and owes $1500 to its depositors. The bank decides that it needs a cash reserve of only 20 percent, or $300; it is therefore free to lend any cash it has beyond that amount. You have learned previously that, when a commercial bank makes a loan, it generally does not give cash to the borrower. It credits the amount of the loan to the deposit account of the borrower (Lesson 26). Suppose that the bank were to lend the $700 of surplus cash. It would, in so doing, increase its deposit liabilities from $1500 to $2200. The bank would still have the $1000 in cash. At the moment of making the loan the reserve ratio of the bank would be:

$$\frac{\text{cash}}{\text{deposits}} = \frac{\$1000}{\$2200} = \text{approximately } 45\%$$

If 20 percent is the minimum reserve ratio which is considered safe, the bank has more cash than it needs for its present deposits. It can obviously lend more and expand its deposits further. Cash on hand is $1000; the proposed reserve ratio is 20 percent. Computation tells us that $1000 is 20 percent of $5000, which means that on the basis of $1000 cash, deposits can be built up, through loans, to $5000.

This further increase of $2800 in deposits represents additional funds which borrowers can draw upon. This $2800 did not exist before the loans were made; it was "manufactured" by the bank's lending process. The commercial bank is thus increasing the amount of "money" (medium of exchange) in existence and in use.




**The "foundation" of the structure in the drawing shows the cash in reserve. The "first story" is the deposit liability resulting from accepting the cash deposit. In the first drawing there are no additional "stories" because the legal reserve is 100%. In the second case, the legal reserve is 50% and therefore only one additional story can be erected. With a 20% legal reserve requirement, in the third drawing, four additional stories can be erected.**

It is possible, however, that depositors' withdrawals will become greater than new deposits. Each business has seasons when a great deal of spending is done to produce goods, or to buy merchandise. At such times the bank's reserve of cash will shrink. The banker must constantly observe the ratio of cash to deposits. As his reserve ratio approaches the minimum for safety, he will either have to reduce his lending, or get more cash by selling liquid assets or by borrowing from another bank. The reserve ratio, therefore, is an important factor determining the amount of lending a commercial bank will do. In order to ensure sound practice, banking law fixes minimum reserve ratios. A *legal-reserve* requirement is a minimum reserve ratio set by law. By raising legal reserve requirements the government may try to discourage bank lending. Suppose, in the example that has been given, the legal reserve was first 20 percent, and was then raised to 25 percent. The government would thus have forced the bank to restrict its deposits to $4000, instead of $5000, on the basis of the $1000 reserve. In this way it could have prevented further lending by the bank.

Not all of the bank's cash is used as a basis for short-term business loans. The demand for such loans varies according to the seasons and according to business conditions. Moreover, it would not be wise, from the viewpoint of safety, to have all the cash tied up in business loans. But idle cash means a loss of profits. The bank therefore invests some of its cash in government bonds, and in the stocks and bonds of outstanding corporations. These investments may not bring so large a profit as the short-term loans, but they are highly liquid assets. They can generally be quickly sold without loss of value, if the bank should suddenly need cash.

### Social Aspects of Credit

Credit, properly used, is of outstanding benefit to society. Savings which might otherwise remain idle help make the wheels of enterprise go around. This increases total production, employment, and consumption, raises national income, and improves standards of living. Idle dollars profit nobody.

*Unfortunately, however, controlling the rate of flow of money and* credit is no easy task. Over optimism, over pessimism, or errors of judgment by the banking institutions controlling the flow of credit, may at one time cause the channels of trade to freeze and at another time to flood. A contraction of credit may produce a deflation in prices and production; an expansion of credit may be the basis for overspeculation, finally resulting in collapse and failure.

To change the figure of speech, credit connects our business and financial enterprises in an invisible but mighty chain. Failure in one cor-

ner of the economy spreads rapidly until it may cover the whole economy and indeed the whole world.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| barter | monetary reserves |
| bullion | money |
| convertible paper money | reserve |
| deposit money | reserve ratio |
| depreciation | specie |
| legal reserve ratio | standard coins |
| legal tender | subsidiary money |
| medium of exchange | token coins |

### II Questions and Problems

1) State, explain, and give an example of, each of the three functions of money.
2) Why has gold been the main basis of money systems in modern times?
3) Show why money has gradually changed from coins to paper money to checks. Why are checks not generally acceptable?
4) (a) Why are deposits a liability? (b) Why doesn't a bank's cash on hand have to be as large as its total deposit liabilities? (c) How does this make it possible for commercial banks to "manufacture credit"? (d) State two factors determining the reserve ratio a bank will keep.
5) Explain the effect of each of the following on the various items in the bank balance sheet below and on the bank's reserve ratio: (a) a deposit of $500 in cash; (b) a withdrawal of $1000 in cash; (c) a loan by the bank of $3000 for 60 days; (d) a purchase by the bank of $5000 worth of government securities.

| *Assets* | | *Liabilities and Capital* | |
|---|---|---|---|
| Cash | $ 50,000 | Capital Stock | $ 60,000 |
| Loans and Investments | 40,000 | Deposits | 80,000 |
| Building | 20,000 | | $140,000 |
| Government Securities | 30,000 | | |
| | $140,000 | | |

6) On the basis of the balance sheet as shown in question 5, what is the maximum deposit liability possible if the legal reserve ratio is 20%?

### III Things To Do

1) Read and report on "Know Your Money," a pamphlet issued by the

United States Secret Service to help people recognize counterfeit money.
2) If possible, visit a collection of various kinds of ancient and modern money, like that of the Chase National Bank in New York City.
3) Bring to class any old or unusual money that you may have.
4) Clip from a newspaper an example of a bank balance sheet. (They generally are published quarterly, in January, April, July, and September.) Your local bank may have a copy of its balance sheet available. (a) Report to the class on the items which it shows. (b) Compute the reserve ratio of the bank.

# LESSON 46 THE EFFECTS OF INFLATION AND DEFLATION

## WHAT THE DEPRECIATION OF MONEY MEANS

Some years ago the government of China raised the salary of its generals to 1½ million dollars a month. Unfortunately for the generals, this salary was paid to them in Chinese dollars; and 1½ million Chinese dollars were at that time worth about $50 in American money. This was an example of extreme inflation.

*Inflation* is a rise of the general level of prices. *Deflation* is a fall of the general level of prices. You have learned about the use of index numbers to measure such economic changes as the movement of prices. The index number of consumer prices and the index number of wholesale prices measure the changes in the *general level of prices,* or *price level.* These indexes are merely averages that show the general direction of prices. They are not intended to show the many differences in the movements of individual prices.

Inflation means that money *depreciates,* or becomes *cheap money;* that is, it is worth a smaller amount of goods and services than formerly. There are varying degrees of inflation. In our economic system there have been frequent periods in which prices have shown a gradual, limited rise; such periods are an expected part of the continual process of change. Extreme inflation, such as took place in China in the 1940's, is a symptom of a breakdown, or near-breakdown, of a nation's economic system.

During and after the recent war there was ample opportunity to observe the operation of extreme inflation, particularly in Europe and Asia. Not only did prices rise to fantastic heights, but also money had little meaning, for there was practically nothing to be bought with the money. As prices soared, workers demanded higher wages to help them meet the higher cost of living. But the rise of wages helped to increase

the cost of goods and services, and pushed prices even higher. The real income of the workers continued to decline. Farmers and businessmen could make large profits by selling whatever goods they had at prices which rose from day to day. Even for them, however, there was the danger that the profits might eventually become useless paper.

Once depreciation sets in, people hesitate to accept money in exchange for their goods and services. A "flight from the currency" begins; people try to exchange the unwanted money for goods or other kinds of money. Under such circumstances a package of cigarettes or a box of stockings is more acceptable than money as a medium of exchange. For the goods which are available, there are two sets of prices: a very high price in terms of the depreciated money, and a lower price in terms of gold or some foreign money which is considered good. During World War II, for example, in many parts of the world, goods had a low price in American dollars, and a high price in local money (Italian, French, Chinese, Greek, for example). If a situation like this continues long enough, prices become so high that the money becomes valueless, and the money system breaks down.

The process of depreciation ends when the unstable conditions which caused it have been partly or completely removed. The nation may start a new money system, as happened in Germany and Russia in the 1920's, and in Hungary in the 1940's. The extreme scarcity of goods may be ended by the return of peace, or by help from another country. The political and financial situation of the government may become more stable, and people may have more confidence in the paper money; the flight from the currency stops.

### Inflation and Workers

As consumers, all people in a nation are hurt by inflation, because dollars buy less. But people are not only consumers; they also receive income or live upon somebody else's income. Most families have some kind of income—wages, profits, interest and dividends from savings and investments, insurance benefits from the government or a private company, and so on. The effect of inflation (or deflation) on any individual or group depends on the relative changes in income and costs for that individual or group.

During World War II, some family incomes in war-plant areas increased from $40 a week to $100, $120, and $150 a week. Wage rates had risen, there was much overtime work, and more members of the family were working. To such families the rising cost of living was a minor problem. At the same time, teachers and policemen and other civil-service employees throughout the country were giving up their

jobs and looking for work in other fields, because their salaries moved up much more slowly than the cost of living.

These are examples of the different effects which inflation has upon various kinds of workers. During good times, highly skilled workers find it easy to get higher wage rates, which help to set higher wage standards for workers in general. The extent to which semiskilled and unskilled workers share in the rise of wages depends on how profitable their specific industries are, and on how strongly organized they are. Experience indicates that wages generally move up more slowly than prices. The "lag" of wages behind prices is greatest for civil-service workers, unskilled workers in nonunion manufacturing industries, and "white-collar" workers in stores and offices.

### Inflation and Businessmen

Businessmen generally prosper in times of inflation, because their selling prices tend to move up faster than their costs. The cost of raw materials rises more quickly than most other prices, but the businessman's other costs rise more slowly. Rent is fixed for a long period of time by lease, in some cases for many years. Debts to banks and other creditors are fixed, unless the businessman decides to borrow in order to expand his business. While his payroll increases, as workers ask for higher wages, the raising of wages comes as the result of long negotiations, sometimes strikes, and is a relatively slow process. At the same time, the increased volume of business helps to reduce the overhead cost per unit. The result is that the businessman, during the inflationary period, not only sells more goods, but also makes a larger profit on each unit. The passage of time in itself creates profits for businessmen, because the rise of prices increases the value of their inventories from month to month. On the other hand, inflation may mean losses for businessmen whose selling prices have been fixed by long-term contracts, and who have to buy materials and labor in a rising market.

This does not mean that all businessmen welcome inflation. Many of them realize that every period of inflation in the past has been followed by a period of deflation, with disastrous consequences for many business firms. Once the inflationary upswing starts, however, few businessmen fail to avail themselves of the opportunity to raise prices and increase profits.

### Inflation and Other Income Receivers

The American farmer has been traditionally in favor of inflation, because his income rises faster than his costs. Most of his production costs are fixed—taxes on his property, debts to the local bank and to

sellers of farm equipment, and maintenance costs. He does have to worry about higher wages for farm labor, higher prices for feed and fertilizer, and higher prices for the manufactured goods he and his family consume. Past experience shows, however, that prices of farm products generally rise faster and higher than the prices of manufactured goods, so that the farmer's real income rises. If the inflation continues for a long time, however, prices of manufactured goods may eventually rise more than farm prices. Then the farmer's real income begins to decline.

Landlords may be hard hit in the early part of an inflationary period, because their operating costs rise, and the rents can be raised only as leases expire. On the other hand, the rise of property values enables them to make profit from speculation in real estate, as well as from construction of new buildings. Furthermore, they are likely to have fewer vacancies than at other times.

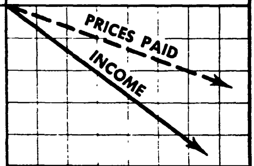
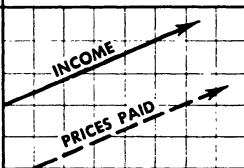
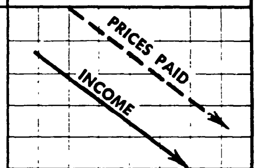
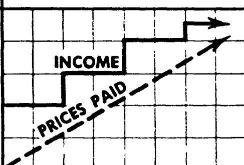
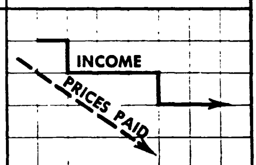
Investors in stocks and bonds gain or lose from inflation according to their skill in adapting themselves to the situation. A man whose money is tied up mainly in bonds, or in other securities which pay a fixed rate, will find his real income declining. It may be to his advantage to shift part of his savings into common stocks, so that he can share in the growing profits of business. A period of inflation may also give speculators a golden opportunity on the securities and commodity markets.

Public utilities, such as electric companies and railroads, do not gain as much from inflation as other businesses. Their rates are regulated by public agencies, and it takes time to get approval for higher rates; meanwhile, their direct costs are rising. This factor is offset, however, by increased volume of business, which substantially reduces overhead cost per unit.

Inflation affects most severely the people who are living on pensions, insurance benefits, interest on savings and investments, and other forms of fixed income. Suppose, for example, that in 1940, William Brown, having reached the age of 65, retired from work, and began to collect a Social Security pension of $40 a month. It was not much; but Mr. Brown and his wife felt that, with the savings they had accumulated, they could manage. A few years later, however, the Browns were asking themselves, "What has happened to our security?" The answer to their question can be found in the chart on page 367. Mr. Brown's real income from his old-age insurance had dropped about 40 percent between 1940 and 1948, because the cost of living had risen over 70 percent during that period.

The effects of inflation and deflation upon the various economic groups is summarized in the chart opposite.

## EFFECTS OF INFLATION AND DEFLATION

| | INFLATION | Economic Groups | DEFLATION |
|---|---|---|---|
| 1st CASE | <br><br>Income rising faster than cost of living, or of doing business. Real income rises substantially. | Farmers<br>Business men<br>Professional men<br>Stockholders of "boom industries"<br>Skilled and well-organized workers, and workers in boom industries<br>Speculators in real estate, commodities, and securities | <br><br>Income drops faster than cost of living, or of doing business. Real income drops. |
| 2nd CASE | <br><br>Income and costs rising at about same rate. No significant change in real income. | Investors in "stable industries"<br>Semi-skilled and unskilled workers, especially in stable industries | <br><br>Income and costs drop at about same rate. No significant change in real income. |
| 3rd CASE | <br><br>Income relatively fixed, changes only at long intervals. Real income drops. | Civil service employees<br>White-collar workers in private business<br>Investors in bonds and preferred stocks<br>People living on savings, insurance benefits, pensions, etc. | <br><br>Income relatively fixed, changes only at long intervals. Real income gains. |
| | INFLATION | Economic Groups | DEFLATION |

The arrows and lines showing *income* and *prices paid* are not actually plotted. The aim is to show the rate of increase or decrease by the slope of the line. Thus, in the first case of inflation, *income* rises faster than *prices paid.* In the third case of deflation, *prices paid* declines steadily, while *income* remains the same for a period and drops at intervals.

### Inflation and Debtors-Creditors

The statement is often made that debtors prefer inflation, whereas creditors fear inflation. This conclusion is drawn from the fact that, in a period of inflation the debtors repay to the creditors dollars which have less purchasing power than when the money was borrowed. Such a statement has value only if properly understood.

Few people are just debtors or creditors; they are also workers, busi-

nessmen, farmers, bankers, investors, or pensioners. Moreover, a great many people are both debtors and creditors. Whether it will be easier or harder for anyone to pay his debts during a period of inflation depends upon which of the three cases, in the chart above, applies to him. Except for the fixed-income groups (Case III), inflation does make it easier to pay debts. But inflation also makes it easier to collect debts, since people have the incomes with which to pay. For these reasons, both creditors and debtors generally prefer inflation to deflation. Each dollar may have less purchasing power, but the dollars come in more easily, and the volume of business is greater.

By way of summary it may be said that the pattern of inflation is a race between selling prices and costs of goods and services. Those who are in a position to raise the prices of their goods and services more quickly than their costs—for example, businessmen, farmers, some workers—gain from inflation. Those whose incomes cannot be raised as quickly as their costs—such as recipients of fixed incomes and some types of workers—suffer from inflation.

### The Effects of Deflation

The effects of deflation upon the community are also illustrated by the table on page 355. In a time of deflation each dollar buys more. During the inflation of the 1940's, people remembered the days of 1931–1932, when butter had been 39 cents a pound, good steaks had cost 35 to 45 cents a pound, and men's suits had been sold in chain clothing stores for $16 to $20. They forgot that national income had dropped from about 80 billion dollars, in 1929, to about 40 billions in 1932. In 1932, $20 a week had been a typical wage, and the number of unemployed had reached a peak of almost 15 millions. Deflation tends to be associated with contraction of incomes and of business activities.

The generalization is often made that the effects of deflation are the opposite of inflation, so that groups benefiting from one are harmed by the other. However, there are complications which modify this general picture. The effect of deflation on any individual or group depends on which of the three cases in the above chart applies. Fixed-income groups gain from the rise in the purchasing power of their dollars, but if the deflation continues for a long time, these groups may find that their incomes begin to shrink. Salaries are cut, many "white-collar" workers are laid off—though at a slower rate than other kinds of workers. Corporations default on their interest payments, and tenants break their leases. No income is permanently fixed. Businessmen and farmers find it increasingly difficult to meet their overhead costs and debts, and the number of bankruptcies rises. Creditors are not happy; because, al-

though each dollar they collect has more value in terms of goods, it is harder to collect the dollars.

There is one kind of deflation that is desirable. That is the gradual, long-run, downward movement of the general price level which takes place as the result of technological progress. As the chart on page 367 shows, in several periods in our history there has been such a downward movement of prices over periods of about ten to twenty years. One of the reasons for such periods of deflation has been that improvements in methods of production made possible a reduction in the prices of many goods. This gradual deflation helps to increase our real income by giving our money incomes more purchasing power. Unfortunately, this long-run deflation has become mixed with periods of sudden, rapid deflation that help to create depression conditions. People therefore fear deflation even more than inflation. One of the problems not yet solved is how to prevent both extreme inflation and extreme deflation.

### Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| cheap money | deflation | inflation |
| | depreciation of money | price level |

II Questions and Problems

1) "The effect of inflation and deflation on any individual or group depends upon the relative rates of change in income and cost." Explain, citing at least two different examples.
2) In 1944 an American newspaper correspondent, while visiting Greece, wrote about paying 75 billion drachmas for a shoe shine. Explain how such a high price was possible.
3) (a) Why did monetary depreciation occur in Europe and Asia during and after World War II? (b) What conditions are needed to bring a depreciated currency back to a stable value?
4) A policeman retired on a pension in 1950, after 25 years of service. He said, "I've been cheated out of my savings, yet there's nobody I can blame." What did he mean? (In your explanation, refer to the chart on page 367. Many of the following questions also are based on this chart.)
5) (a) Show, by referring to the chart, how war affects the general level of prices. (b) Why did some businessmen welcome such a situation? (c) Why did some businessmen fear such a situation?
6) Name two periods of declining prices. In each case, what do you think was the main reason?
7) If you had been a farmer during the period 1870 to 1895, why would you have voted for free silver? (See Lesson 48.)

8) If you had been a home owner in 1932, and your mortgage was coming due, what would have been your attitude toward proposals for inflation?
9) Mr. Jackson and Mr. Porter each owned a business building in 1910. Mr. Jackson induced his tenants to sign 10-year leases. Mr. Porter got 5-year leases from his tenants. Which landlord was in a better position during the next 10 years?
10) Who was relatively better off during the period 1935–1940, the factory worker or the teacher? During the period 1945–1950?
11) The X Department Store offered to buy the complete output of the Y Sweater Manufacturing Co. for the year 1947, at the same price that the store had been paying the manufacturer during 1946. On the basis of the chart, do you think that the manufacturer should have accepted the offer? Why or why not?
12) During the period 1930–1933 the electric light companies made profits, while other lines of business were losing heavily. Explain the advantages which public utilities had over other industries in this period.
13) During the 1940's many labor unions warned their members not to support inflationary proposals. Why might most workers be opposed to inflation?
14) Why would all groups in the community, even those with fixed incomes, be afraid of a period of severe deflation?

III Things To Do

1) Conduct a poll among your family and friends on the question, "Would you like to have a period of inflation? Why or why not"? Report the results to your class.
2) Look up the Quantity Theory of Money and give an explanation of it. Include a statement of the Equation of Exchange. These can be found in almost any college economics textbook, as well as in encyclopedias.
3) Draw an original cartoon illustrating the effects of inflation or deflation. Note the examples on pages 42 and 60.

## *LESSON* 47 MONETARY STANDARDS

### The Need for a Standard

For about a half-century, ending in the 1930's, the United States and many other countries had a money system known as the *gold standard*. This system grew out of a long history of money systems which failed to perform efficiently the functions of money described in the previous lesson. An interesting example was the situation during the War Be-

tween the States. The government had issued paper money, called *greenbacks*, which were not redeemable in specie; they were *irredeemable*, or *fiat, money*. Very soon, as people lost confidence in this money, it began to circulate at a discount: a dollar in paper money had less value than a dollar in gold. A pair of shoes that sold for $5 in gold might require $7 in greenbacks. This was harmful to trade and unfair to the holders of paper money. It brought home the need for a *uniform currency*, in which all forms of money have the same value at any given time.

It is also desirable that money have a stable value, that is, the same value over a period of years. The *value of money* is its purchasing power in goods and services. Rising prices mean that the value of money is falling. Falling prices mean that the value of money is rising. A person who sells merchandise wants to be sure that the money he receives will be exchangeable, immediately or at any time in the future, for an equivalent amount of goods or services. He wants to feel certain that others will accept the money from him at the same value at which he has accepted it.

### How the Gold Standard Functons

The purpose of the gold standard was to provide a *sound money;* that is, a money which was uniform and stable. To achieve this goal, the following were developed as the characteristics of the gold standard:

First, the *money unit* was defined as containing a fixed amount of gold. There was to be a legally established *standard coin*, made of a definite weight and *fineness* (purity) of gold, equal in value to the face value of the coin. In our country the dollar is legally defined as containing $15\frac{5}{21}$ grains of $\frac{9}{10}$ fine gold, equivalent to approximately $13\frac{7}{10}$ grains of fine gold. (Gold coins are not made of pure gold, but contain some alloy for greater durability.) Since there are 480 grains in an ounce, the price of gold in our country is legally fixed at $35 an ounce. (480 divided by 13.7+ equals 35.) Before 1933, when our standard gold dollar contained 23.22 grains of pure gold, the price of gold was $20.67 an ounce.

Second, the price of gold was fixed by the government and kept at the fixed value by the government's buying and selling of gold. When our country was on the gold standard, before 1933, the price of gold could not be higher or lower than $20.67 an ounce. The government was required by law to buy all gold that was brought to it, at a price of $20.67; no one would, therefore, sell gold for less than that price. This requirement is referred to as *free coinage;* the word "free" is used here as meaning "unlimited." The government was also required by law to sell gold without limit to anyone at the legal price of $20.67; no

one would, therefore, pay more than that price for gold. This process of selling gold for other forms of money is called *redemption*. Fixing the price of gold in this way gave the public a guarantee that the *bullion* value (value in metal) of the standard coins would always be the same.

Third, since the government was required to sell gold at the legal price, all paper money circulating in the country could be converted without limit into standard coins. Before 1933 a person could go to any bank, or to the United States Treasury itself, and get standard coins by paying for them with any other kind of lawful money. Few people actually bothered to get gold coins, because paper money was more convenient. But, knowing that the paper money was convertible into gold, they regarded the paper money as the equivalent of standard coins.

Fourth, the government allowed a free market for gold. People could buy and sell gold at any time and in any quantity they wished. They were free to give or accept any price they wished; but, as we have seen above, the price was *pegged* (fixed by buying and selling at an established price) by the government. People had a right to melt the gold coins into metal for industrial purposes, or for any other reason. They could export the gold to other countries, or import it from other countries.

Fifth, the standard coins were full legal tender for debts.

### The Silver Standard and Bimetallism

The requirements for a *silver standard* were the same as those for a gold standard, except that silver was used instead of gold. In recent times China was the only important country to have a silver standard, and China abandoned this system in the 1930's.

There has also been a money system which used gold and silver as the standard at the same time. This system was *bimetallism*. There were two standard coins, one of gold and one of silver. The prices of both gold and silver were legally fixed. All paper money was convertible into either gold or silver, so that gold and silver were interchangeable at a fixed ratio.

The United States maintained a bimetallic system during the first half of the nineteenth century, as did a number of European countries. This system was generally discarded, however, when the huge discoveries of silver in the western part of this country made that metal too plentiful and too cheap to serve as sound money. The abandonment of bimetallism was furthered by the discoveries of gold in California and Australia. Increased gold reserves made it easy for the United States and most European countries to adopt the gold standard. Great Britain had adopted the gold standard as early as 1816.

### The Advantages of the Gold Standard

For nearly a half-century, from the 1870's to the time of World War I, the gold standard seemed to provide a fairly sound money system for the world as a whole. It provided safety, in that people could ask for and get the standard gold coins, whenever they wished. It provided convenience, since people could use whatever kinds of money were most convenient and efficient, knowing that all these other kinds of money were convertible into gold.

Above all, the gold standard met, as closely as seemed to be possible, the two requirements of a sound money. It provided a uniform currency. Since all other forms of money were redeemable in gold and were the equivalent of gold, people accepted paper and gold at the same value. The gold standard never succeeded in establishing a perfectly stable currency, as can be seen by a glance at a chart of price levels. Yet people had confidence in the value of money, because the gold standard provided an automatic check on the amount of paper money which could be issued by the government. The government knew that any loss of confidence in the financial condition of the government would lead to a "run" on the government's *gold reserves* (a supply of gold kept in government vaults as backing for the money system). People would turn in the paper money for gold, and then hoard or export the gold. Eventually the gold reserves would be exhausted, and the money would depreciate. The gold standard thus forced the government to manage its financial affairs in such a way as to avoid the issuance of excessive amounts of paper money.

At the same time the gold standard provided means for expanding the supply of money to meet the needs of the community. Governments learned from experience that it was not necessary to have a dollar's worth of gold kept in reserve for every dollar of paper or token money in circulation. A reserve of $25 to $40 for every $100 of paper money was normally more than enough to take care of the occasional demands for gold. In other words, a *reserve ratio* of 25 to 40 percent was an adequate basis for the successful functioning of the gold standard. The reserve ratio is the amount of gold in reserve divided by the amount of money in circulation. For every dollar of gold which a nation possessed, it could safely put several dollars of paper money into circulation.

Another important benefit of the gold standard, when used on a world-wide basis, was that it provided a uniform money system for the world as a whole. Although every country had its own money unit—dollar, pound, franc, peso, mark—all countries on the gold standard had a common measure of value, by comparing the gold content of their standard coins. (See page 565.)

THE BREAKDOWN OF THE GOLD STANDARD

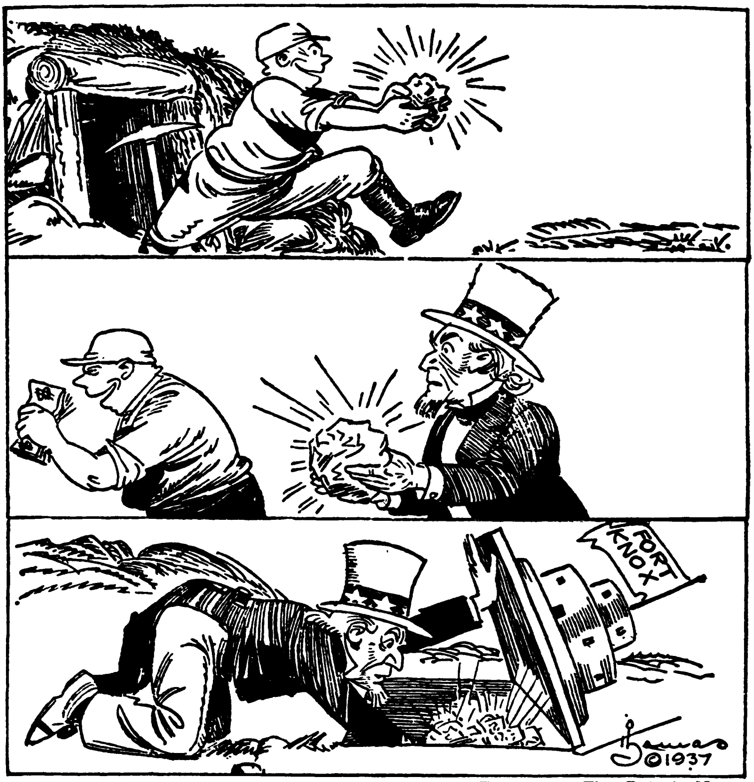
Despite these advantages, the gold standard has been abandoned throughout the world. When World War I broke out in 1914, the European countries which were on the gold standard suspended the privilege of convertibility, because they feared the loss of their gold reserves. Many of these reserves eventually had to be sent to the United States and to the countries of Latin-America to pay for munitions and food supplies. As the financial strain of the long struggle grew worse, most of the warring nations had to issue fiat money to pay their armies and to buy supplies within the country. Gradually this fiat money depreciated as people lost confidence in it, until in some of the European countries—Germany, Austria, Italy, Russia—the value of paper money was virtually zero.

After the war, economic conditions in Europe became more normal, and most of the European countries reëstablished the gold standard. The depression of the 1930's made it difficult, however, for nations to stay on the gold standard. There was a general loss of confidence, paper money was turned in for gold, and nations feared the exhaustion of their gold reserves. By 1940 the gold standard had been abandoned throughout the world, perhaps permanently.

Now we have money systems which are based on fiat money plus certain features of the gold standard. The monetary unit is still defined by law as a fixed amount of gold. No standard coins are in circulation; only inconvertible paper money and subsidiary coins. Many countries maintain gold reserves in order to keep the confidence of the public in the paper money, but these gold reserves are not available to the public. Some countries allow gold to be bought and sold in the open market; some do not. In the United States all gold produced in this country, or imported into this country, must be sold to the government. No one may have more than $100 worth of gold coins or bullion in his possession. Industrial users of gold, such as jewelry manufacturers and dental laboratories, get licenses from the Treasury, allowing them to buy gold for their businesses. Gold can be shipped out of the country only by banks, under special license from the Treasury. Thus there is no longer a free market for gold. Nor can paper money be converted into gold. All paper money is full legal tender. The money system of this country is usually described as an *international gold bullion standard,* because the use of gold as a medium of exchange is primarily in the form of bullion used in international payments.

Whether fiat-money systems can provide, for any length of time, the sound money which we discussed at the beginning of this lesson, we do not yet know. In the United States a modified fiat-money system has worked well since 1934. We have had the advantage of being the

strongest financial nation in the world, with a gold reserve of more than twenty billions to back our paper money. During the 1930's, Great Britain, the Scandinavian countries, and others succeeded in maintaining a stable money system on a fiat-money basis. As a result of World War II, however, the monetary systems of many countries, especially in Europe and Asia, were greatly weakened, and there was a




Thomas in The Detroit News.

The title of this cartoon was "The Mysterious Cycle of Finance." It poked fun at gold buying when gold reserves were already in excess of need.

fantastic degree of *inflation,* or rise in prices. Some economists have claimed that this widespread inflation was the result of failure to maintain a gold standard. Fiat-money systems, they argue, provide no automatic check on the amount of paper money issued, and therefore easily lead to inflation. Other economists have said that the basic cause of the inflation was the extreme scarcity of goods resulting from the war. Neither the gold standard, nor any other money system, in their opinion, could have prevented the inflation.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | |
|---|---|
| bimetallism | irredeemable paper money |
| fiat money | money unit |
| free coinage | pegged |
| free market for gold | redemption |
| gold reserve | reserve ratio |
| gold standard | silver standard |
| greenbacks | standard coin |
| international gold bullion standard | sound money |
| value of money | |

II QUESTIONS AND PROBLEMS

1) (a) Explain what is meant by a "monetary standard." (b) What difference is there between the gold standard and each of the following: (a) silver standard, (b) bimetallic standard, (c) fiat money, (d) gold bullion standard?
2) (a) Summarize the conditions which must exist for a gold-standard system. (b) Which of these exist in the United States today?
3) (a) What are the advantages of a gold standard? (b) What were the reasons for the abandonment of the gold standard?
4) Some years ago an American newspaper published an article entitled, "Our 22 billions in gold—enormous treasure or just junk"? How would you answer this question? Give reasons for your answer.
5) The international gold standard meant simply that the government guaranteed a stable price for gold. Explain.

III THINGS TO DO

1) Organize a debate or forum discussion in your class on the topic, "Should we return to the gold standard"? You can find materials on this question in the library.
2) In an advanced economics text or an encyclopedia, look up Gresham's Law. How may it apply to a bimetallic standard?

## LESSON 48 THE MONEY ISSUE IN AMERICAN HISTORY

EARLY TIMES

There were at that time, as there have been and still are, in every State select companies of incorrigible fools who thought that a State could, by merely calling a bundle of old rags a hundred thousand pounds, really add one hundred thousand pounds to the wealth of the community . . . For

money had become so scarce that many men who at any other time would have scouted the talk of the paper advocates as the babble of fools, were easily made to believe a debased currency which circulated freely was, after all, much better than a good currency of which they rarely saw a coin . . . . The elections came on, and in the Legislatures of seven States out of the thirteen the paper men counted a majority . . . . On the one side were the importers, the holders of stock, the speculators in cash, as they were called, the moneyed men, and the great body of creditors who, having made their advances in a specie basis, were determined to take nothing but specie in return. . . . [On the other side] were the shopkeepers in the great towns, the merchants in the county villages, manufacturers, and debtors.[1]

With these sharp words a famous historian described the controversy over the issue of paper money in 1786, when the American nation had just finished its war for independence. Coins were scarce because they had to be sent to England and the West Indies to pay for goods imported by the colonists. The scarcity of money hindered trade and kept prices low. The farmers and backwoodsmen found it difficult to sell their crops, furs, and timber at profitable prices. When some of the colonial legislatures decided to increase the supply of money by issuing paper money, Parliament forbade such action. This had been one of the grievances which helped bring on the Revolution.

The postwar monetary situation was chaotic. The Revolutionary War had brought prosperity to the farmers and merchants, because the government had paid high prices for food, munitions, and other supplies. With the war over, the farmers found themselves with surplus crops on their hands. They were unable to pay their debts, and some of them were threatened with the loss of their farms through the foreclosure of mortgages. In Massachusetts the discontent of the farmers led to an uprising known as "Shays' Rebellion." The merchants also faced bad times because the ports of England and the West Indies were closed to them. Trade was hampered by the lack of a sound money system. The paper money issued by the Continental Congress had become virtually worthless, coins were hard to keep within the country, and there was no generally acceptable medium of exchange. Some of the states issued paper money, to help the farmers and merchants. But this money quickly depreciated, since it had no backing and the credit standing of the state governments was low.

The need for the reform of the monetary system was one of the reasons for the Constitutional Convention of 1787. The Constitution gave the federal government the power "to coin money, regulate the value thereof." The state governments, on the other hand, were forbidden to

[1] J. B. McMaster, *A History of the United States,* D. Appleton and Co., 1915, Vol. 1, pp. 281, 290–291.

"coin money; emit bills of credit, make anything but gold and silver coin a tender in payment of debts." These provisions were among the reasons for the widespread opposition to the new Constitution among the farmers. They feared that the business class was conspiring to keep down farm prices by limiting the supply of currency.

### The Controversy over the Bank

Soon after the adoption of the Constitution and the establishment of the federal government, the controversy over the money system again emerged. When Alexander Hamilton, the Secretary of the Treasury, proposed the establishment of a central bank (which was called the Bank of the United States), he represented the business classes, who were seeking the establishment of a sound currency. Although the state governments could no longer issue paper money, the banks chartered by the state governments could. The result was an increasing quantity and variety of paper money, much of it of doubtful value. It was the hope of Hamilton and his followers that the strong backing of the national bank would make its paper money acceptable throughout the nation. Eventually, he reasoned, the paper money of the national bank would provide a uniform and stable money system.[2]

The farmers of the nation opposed Hamilton's ideas, because they wanted to continue the system of a plentiful supply of paper money, issued by local banks, which were much more liberal than any national bank would be in lending this paper money to the farmers. It was to their interest, the farmers felt, to keep money "cheap." This feeling was based on the *quantity theory of money,* the belief that the value of money is based on the amount of money in circulation. The more money in circulation, according to this theory, the higher prices will be; and the less money in circulation, the lower prices will be. As a result of the farmers' opposition, the charter of the bank was dropped in 1811. In 1816, however, a second national bank was established. The period from 1820 to 1850 was one of deflation. The farmers charged that the national bank was being used by the businessmen and bankers to limit the supply of money, and to "squeeze" the farmers. Led by President Jackson, the farmers prevented the renewal of the bank's charter, which expired in 1836.

The disappearance of the Bank of the United States increased the influence of the cheap-money groups. Since there was practically no

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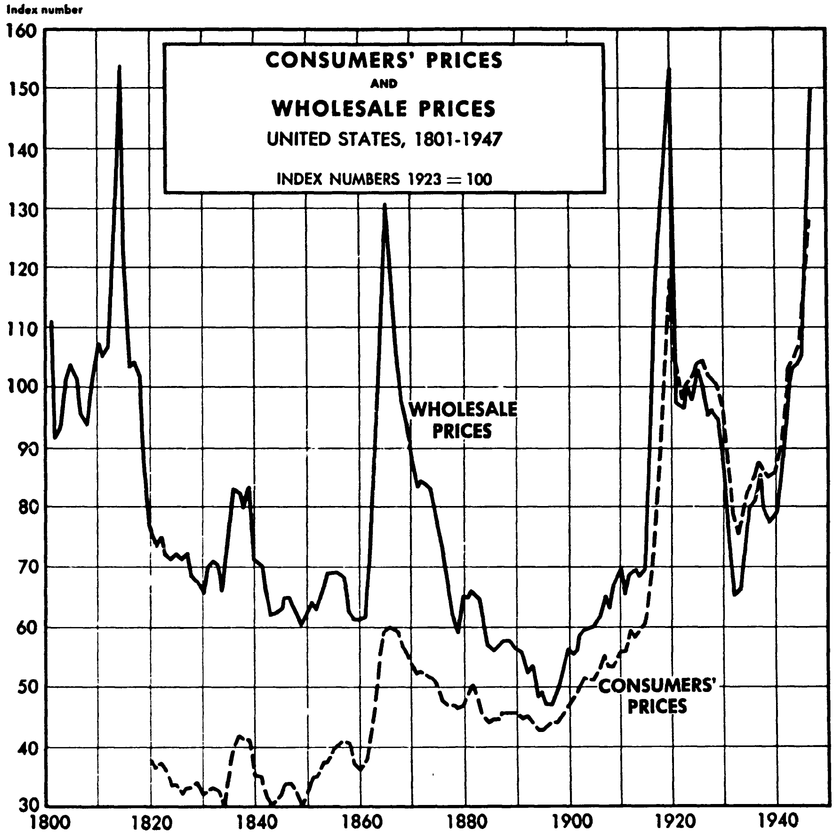
[2] In this lesson we are discussing the national bank only with reference to the money issue. There were a number of other aspects to the controversy over the bank. See Faulkner and Kepner, *America: Its History and People,* Fifth Edition, Harper and Brothers, pp. 216–217; also Faulkner, Kepner, and Merrill, *History of the American Way,* Harper & Brothers.




Each of the sharp peaks represents a postwar period of inflation. Note that each peak (except the most recent) has been followed by a correspondingly sharp decline. The period from 1865 to 1896 was one of constantly declining wholesale prices. What is the connection between this fact and the monetary demands of farmers during this period? (Redrawn from Road Map of Industry No. 626, National Industrial Conference Board)

regulation of banking, many "wildcat" (unregulated) banks were opened, and issued their own paper money. This money helped the farmers to buy land in the West, as long as the government was willing to accept it. But when Jackson's administration, by the Specie Circular of 1836, stopped accepting paper money for land, the money issued by many of the banks became worthless. Many banks had little or no gold and silver as backing for their paper money. Bank failures were numerous, the money system was confused, and businessmen had to adjust prices according to the kinds of money offered them by customers. Under such conditions it was diffcult to carry on business.

During the War Between the States the federal government reformed the country's money system. The government instituted a system of national bank notes, and by taxing paper money issued by state-chartered banks, drove them out of existence. For the first time this country had a uniform currency, backed by government bonds and gold reserve.

### The "Free Silver" Campaign

The War Between the States brought prosperity to the businessmen, farmers, and workers of the North. This prosperity lasted through a postwar boom that came to an end in 1873. Then began a deflationary trend which continued for a quarter of a century. It meant a gain in the buying power of the dollar. To the farmers, however, it seemed to spell disaster. Again they sought a way out through cheap money, and started a battle which lasted twenty years.

The government had paid part of the expenses of the war by issuing fiat money, officially designated as "United States Notes," but popularly called "greenbacks." Now that the financial crisis of the government was over, the government proposed to retire the greenbacks from circulation, so that there would be no more fiat money in our money system. The Resumption Act of 1875 made the greenbacks redeemable in gold, beginning in 1879. But it was agreed that the greenbacks were not to be retired from circulation; they are still part of our money system. This was merely the beginning of the cheap-money campaign, which then turned to the "free-silver issue."

In 1792, the government had established a bimetallic money system. Until the middle of the nineteenth century, however, our coinage system had little meaning. The coins minted by the government were used to pay for imports or were melted for industrial use, and domestic business was carried on mainly with paper money. The California gold rush of 1849, and the discovery of gold in other parts of the world, made it possible to have gold coins in circulation and to accumulate gold reserves for our money and banking system. Silver coins continued to be scarce until the 1870's.

In 1873 a law was passed reorganizing our coinage system. The standard silver dollar was discontinued; all silver coins were to be of the subsidiary type. Practically, from 1873 on, we were on the gold standard, instead of on a bimetallic standard. Little attention was paid to the change at the time, because the law merely confirmed an established fact. Shortly afterward, however, vast silver deposits were discovered in the Rocky Mountain region. The value of silver dropped so much that it was no longer desirable as a standard money. Those European nations which were still using the bimetallic system adopted the

gold standard. This step reduced the demand for silver at the very time when the supply was being rapidly multiplied. The silver interests in this country were desperate, because they no longer had a legally guaranteed price for their product. The bottom had dropped out of their market. But they had ready allies in the Western farmers, who felt that the bottom had dropped out of their market, too.

The silver-mine owners and the farmers' organizations denounced the 1873 law as the "Crime of '73." They charged that the Wall Street bankers had brought about the dropping of "silver" in order to bring prices down. They dramatically pictured debtors, especially the farmers, as being forced to repay their debts with "dear" dollars which would have more purchasing power than the "cheap" dollars they had borrowed during the inflation of the 1860's and early 1870's. A campaign was started for the restoration of the bimetallic system.

The Bland-Allison Act of 1878 was a compromise. It required that the government buy a specified value of silver each month and to coin silver dollars. By this law the farmers got more money into circulation, and the silver interests got a market for some of their surplus silver. This measure did not, however, bring an end to the deflation of farm prices; nor were the silver companies satisfied. They continued the drive for *free silver,* that is, the free coinage of silver and the reëstablishment of bimetallism. This would have required unlimited purchase by the government of all silver brought to it, at the former legal price of $1.29 an ounce, well above the actual market price. The Populist movement tied the cheap-money issue together with demands for regulation of railroad rates, curbs on monopoly, and improved working conditions. In 1890 a partial victory was scored, when the Sherman Silver Purchase Act was passed. This law increased the amount of silver to be purchased by the government each month. It was repealed in 1893.

With the election of 1896, the "free silver" campaign came to a climax. The defeat of William Jennings Bryan by William McKinley meant the triumph of the business groups over the combined forces of the farmers, silver interests, and labor, and put an end, for the time being, to the cheap-money campaign. The Gold Standard Act of 1900 formally reorganized our money system on a gold-standard basis, which lasted until 1933.

### The Cheap-Money Issue in the 1930's

About 1896 the deflationary trend of prices, which had started in 1873, ended. For the next twenty-five years there was an inflationary trend, reaching a peak in 1920. (Note the chart on page 367.) During this period American farmers were better off. The cheap money issue

subsided, not to be revived until the 1930's brought a rapid deflation.

The depression of 1930–1933 created an interest in the possibility of forcing prices upward through expansion of the money system. Although the demand for cheap money was nation-wide, it came most vehemently from the farming areas and from the silver states. The silver states now had sixteen votes in the United States Senate; the combination of silver-state and farm-state votes dominated the Senate.

The Agricultural Adjustment Act of 1933 contained a section known as the "Thomas Inflation Amendment." This section allowed the President to use three methods of expanding our currency: (1) to *devaluate the dollar* by reducing its gold content, (2) to issue up to three billion dollars of greenbacks, and (3) to restore the bimetallic system.

Only the first of these methods was used by the President, who reduced the gold content of the dollar by about 41 percent, from 23.2 grains of pure gold to 13.7 grains. This change was officially recognized under the Gold Reserve Act of 1934. This had the effect of fixing the price of gold at $35 an ounce, instead of the previous $20.67. Theoretically, this was supposed to mean an increase in the amount of money in circulation, since every ounce of gold now represented $35 instead of $20.67. The actual effect of this step was uncertain. Still unsatisfied, the cheap-money groups pushed through the Silver Purchase Act of 1934. This law requires the Treasury to buy all silver produced within the country at a price fixed by Congress. The price fixed by Congress from time to time has, of course, been substantially above what silver would bring in the open market. The law also authorizes the Treasury to buy as much foreign silver as it may wish. Although it is doubtful whether this law has in any way affected the prices of farm products, it has given the silver producers of this nation a guaranteed market.

The war boom of the 1940's brought to an end another cheap-money era in our history. The cheap-money issue has been an excellent example of the saying that history repeats itself.

### Exercises and Activities

I Dictionary of Economic Terms

| | |
|---|---|
| devaluation of the dollar | quantity theory of money |
| "free silver" | national bank |
| greenback | wildcat bank |

II Questions and Problems

1) Arrange the following items in two columns, headed "Cheap-Money Policy" and "Dear-Money Policy." Be able to explain why you placed

each item in a particular column. (a) Constitution of the United States (1787), (b) Bank of United States (1792–1811, 1816–1836), (c) Specie Circular (1836), (d) national bank notes (1863), (e) "Crime of '73" (1873), (f) Bland-Allison Act (1878), (g) devaluation of the dollar (1934), (h) Silver Purchase Act (1934).

2) (a) Explain how, in the case of the silver issue, history has repeated itself. (b) Why has the silver issued appeared chiefly in the United States during the past 75 years? (c) Why have the farmers and silver-mine owners been allied on this issue?

3) Write a letter, such as you might send to your Congressman, explaining why you favor or oppose one of the following: (a) further devaluation of the dollar, (b) government buying of silver at a legally fixed price.

4) Why is each of the following dates a key date in American monetary history? (a) 1792, (b) 1834, (c) 1863, (d) 1873, (e) 1879, (f) 1900, (g) 1933–1934.

III Things To Do

1) Copy and bring up to date the chart showing the movement of prices (p. 367).

2) Read *The Age of Jackson* by Arthur M. Schlesinger, Jr., which in some parts discusses the money controversy of the early nineteenth century.

# *LESSON 49* THE FEDERAL RESERVE SYSTEM

## The Need for a Central Bank

The commercial bank is a business firm. The management of a commercial bank has a responsibility to the stockholders of the bank to run the bank efficiently and profitably. It needs to make wise loans and investments. But the management also has a responsibility to the depositors to keep the assets of the bank liquid, so that deposits can be withdrawn on demand.

The individual bank may find it hard to fulfill these responsibilities successfully. When business becomes "tight" and businessmen need more credit, it may be difficult for banks to grant further loans. They have loaned so much that they are down to the minimum reserve ratio. Some business firms, unable to get further credit, are forced into bankruptcy, and the chain of credit snaps. If businessmen lose confidence and begin to withdraw deposits on a large scale, the banks may not be able to meet fully the demands of the depositors. A *financial panic,* an overwhelming demand for cash, results; and many banks are forced to close down.

Financial panics of this type have occurred in this country a number of times. One of the key factors in most of these panics was the fact that the individual banks had no way to get further reserves. Additional reserves would have enabled them to continue to make loans to businessmen in those "tight" situations when more credit was needed; and to meet the depositors' unusual demands for cash.

The solution for this problem was sought in the establishment of a *central bank,* a bank which is created for the purpose of performing specific services for the commercial banks in the community. Because it deals almost exclusively with banks, rather than with businessmen, it is called a "bankers' bank."

Nearly every important country now has a central bank. In most countries this is a single large bank. Sometimes it is privately owned, but supervised by the government. In other cases it is owned and operated by the government. In the United States there is a group of twelve central banks, called *Federal Reserve Banks.* They are privately owned but supervised by an agency of the federal government, the Board of Governors of the Federal Reserve System. This system was established by a law passed in 1913, following the panic of 1907.

STRUCTURE OF THE SYSTEM

The United States is divided into twelve Federal Reserve Districts, and in each district there is a Federal Reserve Bank, located in one of the largest cities in the district.

Each Federal Reserve Bank is owned by the hundreds of individual banks in the district that are members of the Federal Reserve System. Altogether, there are 7000 *member banks* in the Federal Reserve System. If your local bank is a member of the system, that fact is indicated by a statement on its front window. The member banks are required to purchase the stock of the Federal Reserve Bank of the district, which thus obtains the capital for its own business transactions.

There are in the United States 15,000 individual banks. Five thousand of them are *national banks,* chartered by the national government, and required by law to be members of the Federal Reserve System. The remaining 10,000 are *state banks,* chartered by the different state governments and permitted to join the Federal Reserve System. Only 2000 of the state banks belong to the Federal Reserve System. They include, however, nearly all of the large and important banks; the member banks of the Federal Reserve System do 80 percent of the total banking business of the country.

The Board of Governors of the Federal Reserve System, popularly called the Federal Reserve Board, consists of seven members, chosen by the President of the United States.

SERVICES OF THE FEDERAL RESERVE SYSTEM

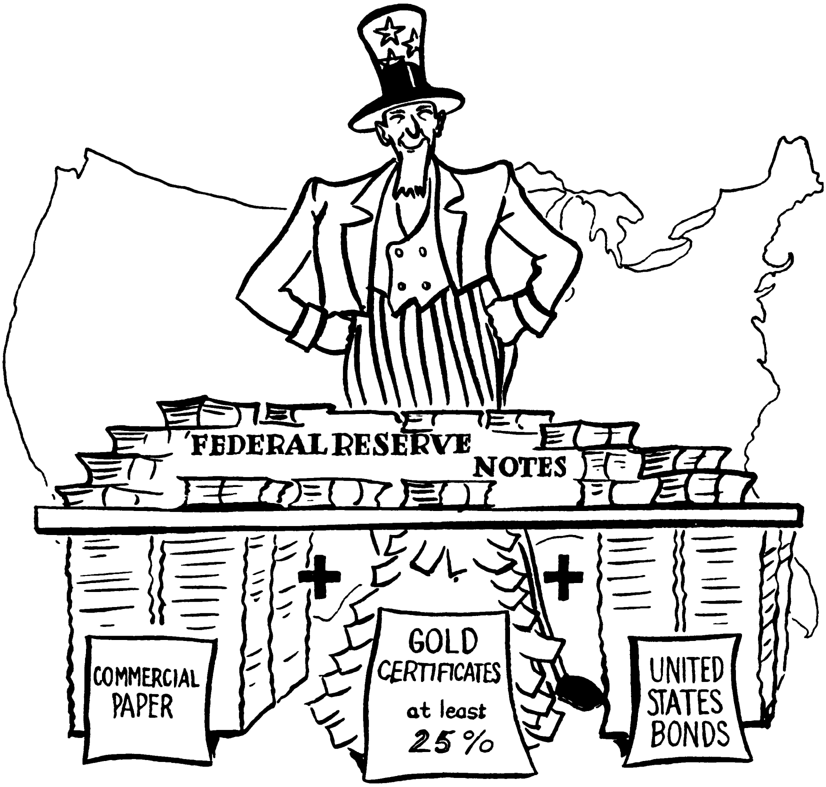
The services which the Federal Reserve Banks render to the member banks are the same as those which the member banks render to their customers, the businessmen.

The Reserve Banks hold as deposits most of the cash reserves of the member banks. The law requires the member banks to keep their legal reserves in their respective Reserve Banks. The member banks must maintain the following reserve ratios (as of January, 1950) against their demand deposits: In New York and Chicago, 22 percent; in 58 other large cities, 18 percent; in all other communities, 12 percent. The required reserve ratio against time deposits (see page 196) is 5 percent.

The Reserve Banks also may lend money to the member banks, whenever the latter need additional reserves. These loans are based on promissory notes signed by the member banks, with satisfactory collateral. Member banks may also borrow from the Reserve Banks by rediscounting promissory notes and other types of negotiable credit instruments which they have received from businessmen. To *rediscount* a promissory note, the bank endorses it after having discounted it for its customer. The effect is the same as if it had borrowed on its own promissory notes.

The Reserve Banks supply the member banks with currency—paper money and coins—to meet the needs of the business world. When businessmen need more currency for retail operations, or for payrolls, they get it from their banks. If the banks have not enough currency in their vaults, they get more by making withdrawals, in the form of currency, from their accounts in the Federal Reserve Banks. In order that the business world may have enough paper money, the Federal Reserve Banks issue Federal Reserve Notes. These notes constitute over 80 percent of our supply of paper money. The Federal Reserve Banks must have a 100 percent reserve against these notes, of which not less than 25 percent is in gold certificates; the rest is in government bonds and *commercial paper* (promissory notes and drafts of business firms).

The Federal Reserve Banks also perform services for others besides their member banks. They act as the *fiscal agents*, or bankers, of the federal government. Government funds, such as tax collections, are deposited in these banks. When the government wants to pay any of its obligations, such as employees' salaries, veterans' bonuses, or money due on bonds, the Treasurer of the United States draws checks on the government accounts with Federal Reserve Banks. These banks also help the government do its borrowing by handling the sales of government bonds. (Commercial banks also act in these various capacities for the government.) Finally, the Federal Reserve Banks have some limited and incidental relations directly with the business world.




**Federal Reserve notes make up about 85% of the money in circulation. Besides their formal backing shown in the drawing, they rest upon the credit of the United States government.**

Each Federal Reserve Bank acts as a clearing house and collection agency for the commercial banks in its district. Going a step further, the twelve Reserve Banks maintain an Inter-District Settlement Fund for clearing balances due from one Reserve Bank to another.

In performing these services for the banking community, the Federal Reserve Banks have increased the efficiency and safety of our banking system. The requirement that the member banks keep their reserves as deposits in the Reserve Banks has the effect of *pooling the reserves.* The reserves of the individual banks are brought together in a central institution, from which they can be channeled to any banks which may need them. You have seen how the commercial bank pools the surplus funds of businessmen, by holding their deposits; it shifts the funds, by means of loans, to businessmen who need the funds. Each Reserve Bank does the same thing for the commercial banks. It is required to maintain a

reserve of 25 percent against its holdings of member banks' deposits. It can lend the surplus funds to member banks. The Reserve Bank thus becomes a "reservoir of credit," from which commercial banks can get additional funds, through loans, when their reserves are low.

### Maintenance of Sound Credit Conditions

There are several ways in which the Federal Reserve System has tried to control the amount and kinds of credit used in the community. One way is through changing the legal minimum reserve ratio for the member banks. The lower the minimum reserve ratio, the more money banks can lend, and the greater the possibility of inflation in the business world. Raising the minimum reserve ratio tends to limit the amount of loans which can be made by banks, and this may curb inflation. Since 1936 the required reserve ratio has been nearly doubled.

Another device for control is the rediscount rate, the interest rate charged by the Federal Reserve Banks for loans to member banks. Raising the rediscount rate makes borrowing more expensive, and may help to check the amount of lending which the member banks do to businessmen. In actual practice, in recent years, the reserves of commercial banks have been so large that their borrowing from the Reserve Banks have been insignificant. The rediscount rate has, therefore, been unimportant as a means of controlling credit.

More important has been a device called *open market operations*, the buying and selling of government securities and certain other financial instruments by the Federal Reserve Banks. When the Reserve Banks buy securities from dealers in the open market, the checks paying for the securities are deposited by the dealers in the commercial banks. This increases the reserves of the commercial banks, and increases their lending power. Thus the aim is to encourage the commercial banks to expand their loans to businessmen. On the other hand, when the Reserve Banks sell securities to the dealers in the open market, the dealers pay with checks drawn against their accounts in the commercial banks. This reduces the lending power of the commercial banks, and is intended to discourage business loans. In addition, the Board of Governors relies upon "moral pressure" and advice to influence the banks of the country to follow its credit policies.

The Federal Reserve System has also been given control over other types of credit than commercial bank loans. The Board of Governors establishes margin requirements for stock-market speculation. During the 1940's, it also regulated consumer loans and installment buying.

The ability of the Federal Reserve System to control the expansion and contraction of credit effectively is doubted by many authorities. The Federal Reserve System was unable or unwilling to prevent the

expansion of credit in the 1920's. This expansion of credit helped to bring about the excessive speculation in securities and real estate, which led to the "crash" of 1929. In the 1930's the Federal Reserve System had little success in its efforts to stimulate expansion of credit in order to promote business recovery. Experience shows that if the business outlook is doubtful, businessmen will not borrow, and banks will be reluctant to lend. Plentiful reserves and low interest rates do not, in themselves, lead to the use of credit. In good times, when profit-making opportunities are substantial, high interest rates do not restrain businessmen from borrowing.

Although the establishment of the Federal Reserve System has not solved all the problems of our credit system, it has achieved some successes. It has improved the efficiency of the banking system in the various ways which have been described. By regulating "margins" it helped to limit speculation on the stock market during the boom of the 1940's. Its regulation of consumer credit also helped to limit inflation during this period. The Federal Reserve Banks helped the government to sell hundreds of billions of dollars' worth of bonds and other securities, by buying and selling these securities at a fixed price. But the Federal Reserve System did not prevent the disastrous deflation of the 1930's, or the inflation of the 1940's.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| Board of Governors | fiscal agent | open market operations |
| central bank | interdistrict settlement fund | pooling of reserves |
| commercial paper | member bank | rediscounting |
| Federal Reserve Bank | national bank | state bank |
| financial panic | | |

### II Questions and Problems

1) Explain the general purposes of a central bank.
2) Copy and fill in the table below comparing the functions of a commercial bank with those of a Federal Reserve Bank.

| *Function* | *Commercial Bank—for the Businessman* | *Federal Reserve Bank—for the member bank* |
|---|---|---|
| (1) Receives demand deposits | | |
| (2) Provides credit | | |
| (3) Provides clearance and collection | | |
| (4) Issues money | | |

3) List and explain three important ways in which the Federal Reserve System contributes to the welfare of business and the general public.
4) Explain how each of the following actions by a Federal Reserve bank can limit the ability of member banks to make loans: (a) the rediscount rate is raised, (b) the legal reserve ratios are raised, (c) the investment of Federal Reserve funds in government securities is increased.
5) Explain how the Federal Reserve banks provide for clearance among banks in different parts of the country.
6) Explain how the Federal Reserve System has served (a) to pool or mobilize reserves, (b) to provide currency in accordance with the needs of business, (c) to reduce chances of bank failure.
7) A Federal Reserve Bank can "create member bank reserves" in the same way that a member bank can "create deposits." Explain.
8) Why has the Federal Reserve System been said to create "a reservoir of credit"?
9) Explain why Federal Reserve control of credit has not been fully effective.

III Things To Do

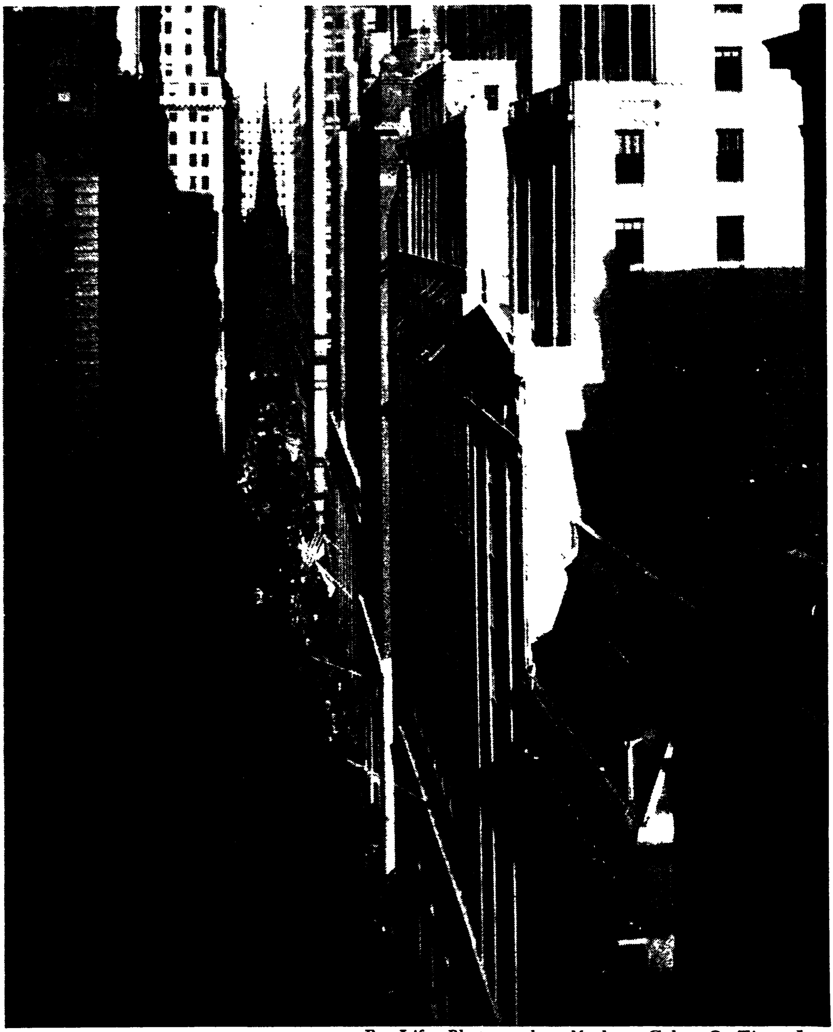
1) Report to the class on one of the following: (a) the Panic of 1907; (b) the first and second "United States Banks" as central banks; (c) the Pujo Investigation (1912); (d) the National Banking System, its origin, contributions, and weaknesses.
2) (a) Find out in which of the three legal reserve-ratio groups your locality belongs. (b) What are the present legal reserve requirements in your locality?

# *LESSON* 50 GOVERNMENT CONTROL OF CREDIT

## The Closing of the Banks

On the fifth of March, 1933, John Jones, having received his weekly pay check, went to his bank, as usual, to cash it. He found the bank closed. On the door was a notice that all banks in the state had been closed until further notice, by order of the governor of the state. Mr. Jones went home, wondering how he was to pay his grocer, his tailor, and his trolley fare. This scene was repeated many millions of times that day in every state in the Union.

It was the dramatic climax of the financial panic of 1933, the worst in our nation's history. During the depression years from 1929 to 1932, thousands of banks had failed, and runs on banks had spread like wildfire. During the last three weeks of February. 1933, more than a billion



By *Life* Photographer Herbert Gehr. © Time Inc.

**Wall Street, heart of the financial section in New York City.**

dollars had been withdrawn from the banks for safer keeping. It had become apparent that it was necessary to do something drastic to protect those depositors who did not withdraw their deposits. Hence the governors' orders closing all the banks.

The banking system was suffering from a very serious ailment. The patient had been patched up on several occasions in our history, particularly by the National Banking Act of 1863 and the Federal Reserve Act of 1913. But these remedies had proved inadequate. The financial

panic of 1933 became one of the first orders of business for the newly elected President, Franklin D. Roosevelt.

President Roosevelt and the Congress took emergency measures to help the paralyzed economy of the nation. Sound banks were gradually reopened under careful control. Loans were extended by the government to banks and to business.

But this was no temporary illness from which our banking system was suffering. The money and banking panic of 1933 merely highlighted the inability of our banking system to keep businesss going by the proper provision of needed funds, the blood transfusion of economics. What is more, the banking system had even contributed to the illness of the economic system by providing funds for excessive speculation. The degree to which the banks were responsible for the collapse of the patient became clearer only after the stock-market crash of 1929 and the financial panic of 1933 had taken their toll. It became even clearer later on, when a Senate investigation disclosed serious weaknesses and indeed some corruption and dishonesty in some of our banking institutions.

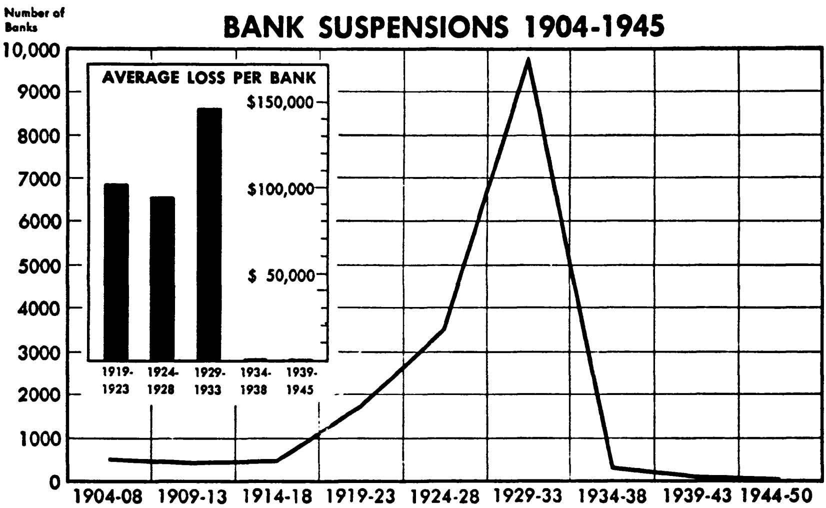
As soon as the emergency seemed under control, a series of drastic changes in our banking system were introduced. These took two forms. closer regulation of the banking system by the government. and the beginning of large-scale operations by the government itself in the money market.

### Why Banks Fail

The chart on page 380 shows the number of bank failures in this country in recent years. At the beginning of the 1920's this country had about 31,000 commercial banks. During the next decade over 5.000 of them failed, although this was mainly a period of prosperity. Between 1929 and 1933, a period of depression, almost 10,000 more banks closed their doors. Why?

One reason was mismanagement and ignorance. A large proportion of the failures were in small banks managed by individuals with capital but with no real training for banking. A second reason was the fact that banks in small communities tended to limit their loans and investments to one kind, for example, farm mortgages. Specialization in lending to one industry meant putting all the bank's eggs in one basket. Trouble in that industry meant that the bulk of the bank's loans could not be recovered quickly enough to repay depositors. A third reason was loss of confidence, or panic. The safety of a bank depends on the fact that all its depositors do not demand payment at once. When business conditions, rumors, or fear create a run on the bank, no matter how sound its policies, no matter how excellent its investments, the bank cannot survive without help.

In general, a bank's condition depends on how fast its depositors (borrowers included) are withdrawing and depositing funds, and how fast the bank is making and collecting loans. When borrowers cannot repay promptly, the bank may sell the collateral or security pledged for the loans, but it may find that it cannot sell this for enough to get back the value of the loans. This collateral or security then becomes a *frozen asset,* an asset which cannot be quickly sold at full value. Failure can be avoided only if help is received to enable the bank to meet its debts to




The number of bank failures mounted steadily from World War I until the nation-wide bank holiday in 1933. The relatively small size of most failed banks is shown in the small insert; the average loss per bank was not very great. Since the adoption of deposit insurance in 1933, bank failures have virtually ended. (Data from Federal Reserve Board)

depositors. Frozen assets are particularly dangerous for commercial banks, because they have to be able to meet large withdrawals of deposits without advance notice.

Bank failures are a serious problem for a number of reasons. In the first place, they cause thousands of depositors to lose their savings, or to wait long periods while assets "thaw out." In the second place, they cause loss to the bank stockholders, who lose their investments in the bank. In the third place, they lead to panic and pessimism which may spread to other businesses. As was explained in the last lesson, credit links together businesses and banks; bank failure tends to spread until nation-wide loss of confidence and depression may result.

A glance back at the chart on this page will reveal that today there

are practically no bank failures. The measures taken to bring this about have involved increasing government regulation.

### Closer Regulation of the Banking System

The remodeling of the banking system took place primarily through the Banking Acts of 1933 and 1935.

*Deposit insurance* was initiated through the Federal Deposit Insurance Corporation (FDIC). Banks in the Federal Reserve System were required to join, and others, including savings banks, were invited to do so. Banks which are members of the FDIC pay a premium equal to a certain percentage of deposits. Depositors are guaranteed payment of their deposits, up to $10,000 in any one bank. For most consumers and wage-earners this is more than enough, although not for business firms with large accounts. When a member bank fails, the FDIC takes over its operations, and sells its assets gradually; that is, the FDIC liquidates the bank. The fact that deposits are guaranteed tends to prevent panic and runs, and helps keep failure from spreading.

Other measures were adopted to protect depositors. The minimum capital required for a national bank was raised substantially, thus giving the depositor greater assurance of adequate reserves. Greater restrictions were placed upon bank loans, investments, and speculations; for example, a bank may not lend money to its officers. The Federal Reserve Board may remove member bank officials who, after being warned, continue to violate the banking laws or continue unsound practices.

An attempt was made to achieve greater unity in the financial policies of the twelve Federal Reserve Banks and the thousands of member banks. The Board of Governors of the Federal Reserve System was given greater power to centralize control over discount rates, reserve ratios of member banks, open market operations, and margin requirements. It has been argued that this centralization of power in the Board of Governors has given the government the ultimate power over the Federal Reserve System. "The Federal Reserve System may now be said to be a government institution."[1]

On the other hand, it must be remembered that our banking system still remains decentralized to the degree that there are forty-eight separate state banking systems. The reforms just mentioned do not apply to the state banks that are not members of the Federal Reserve System, and the unified banking policy is also incomplete to this extent. It is important to note that the few bank failures that have taken place re-

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[1] Ross M. Robertson in *Development of Collective Enterprise,* by Seba Eldridge and Associates, University of Kansas Press, 1943, p. 302.

cently are almost entirely in state banks that are not members of the Federal Reserve System.

THE GOVERNMENT IN THE MONEY MARKET

As a result of the events of the 1930's, the government finds itself a most important factor in the money market—as lender, borrower, and supervisor.

*Wide World*

The Federal Reserve Building in Washington, D.C. Erected in 1937, this building is the headquarters for federal control of commercial banking.

In 1932 the Reconstruction Finance Corporation (RFC) was created by the Federal government, under President Hoover. It was originally an agency mainly for lending funds to banks, insurance companies, and railroads, to help them at a time when these industries were facing financial difficulties. During Roosevelt's presidency its activities were enlarged to aid farming and other industries and governmental agencies, such as housing agencies. During the war it lent large sums to various businesses which needed capital to increase their facilities for war production. The RFC may make a business loan only if such a loan is not available on reasonable terms through private banks.

Farmers, home owners, and low-income city dwellers have been aided by a series of New Deal laws. The government established the Farm Credit Administration (FCA), which combined and expanded the various lending services for farmers. It has also helped farmers to reduce their mortgage debts, by exchanging their old mortgages for new ones with lower principal and interest charges. Similar help in meeting

mortgage debts has been given to homeowners in the cities through the Home Owners Loan Corporation (HOLC). The Federal Housing Administration (FHA) guarantees mortgage loans made by banks for housing construction and improvement, thus making it easier for home owners to obtain such loans. The United States Housing Authority (USHA) has made loans and grants to local public-housing agencies for low-cost housing projects.

The lending operations of the government have been extended to other countries. The Export-Import Bank was established in the 1930's to lend money to governments of other countries. This money was to be used by foreign governments to finance purchases from American businessmen.

At the same time the government has become the greatest borrower in the country. By the midcentury, the amount of the national debt was about 250 billion dollars, as compared with 175 billions owed by all private business firms. Government bonds are an important investment opportunity for all kinds of investors—individuals, banks, insurance companies, industrial corporations, and nonprofit institutions of all kinds.

### The Problem of Government Control

The *money market*—a market in which individuals, business and banking firms, and governments loaned and borrowed funds—was once almost exclusively a private market. The financial operations of the government were a relatively small factor in the money market. Now the government is on both sides of the money market; it is a big lender, and the biggest borrower. The government is in a position to dominate both supply and demand in the money market. "Perhaps nowhere in the whole of the New Deal measures do we find such definitely affirmative action breaking so completely with the old way of doing things as in the establishment and development of the governmental credit agencies."[2]

As a lender, the government can influence the supply of credit available to borrowers. It can encourage expansion and contraction of business operations, by increasing and decreasing its lending operations. It can influence the development of specific industries by lending, or refusing to lend, to businesses in any industry. During the war, for example, it encouraged expansion of the aluminum industry by supplying capital to businessmen who wished to enter that industry. After the war it refused to lend funds to another businessman who was trying to get into the automobile industry. Our government can even influence eco-

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[2] *Ibid.*

nomic developments in other countries through its loans or refusal to make loans.

The government can also influence the interest rates charged in the money market. By lowering or raising the rates on its own loans to farmers, businessmen, and home owners, it sets the standard. The rates charged by banks on mortgage loans have been lowered in recent years largely as a result of the operations of various government agencies. As a borrower, by controlling the market price of government bonds (usually through sales and purchases by the Federal Reserve Banks), the government can also influence the interest rates charged by banks. Under certain circumstances this can influence the amount of lending by banks for speculation and investment.

This indirect control is in addition to the many direct methods of government control of the credit and banking system which have previously been described.

There has been much controversy about the extent and the desirability of this governmental control of credit. Some regard this development as a serious invasion of private enterprise. If the government interferes for the purpose of bringing down interest rates, it reduces the rate of earnings on private investments. If it makes loans to various industries, it may be able to decide who shall, and shall not, be in business; and how much competition or monopoly there shall be in any industry. Government control of credit, in the opinion of certain critics, is leading us toward socialism.

Others say that, on the contrary, government control of the money market is for the benefit of the business world and for the general welfare. The government can, if it wishes, increase the supply of capital at low rates of interest, thereby encouraging industrial development. Through its borrowing and lending, it may help to create business and employment at times when we are threatened with depression. It can also regulate competition and monopoly, by lending or refusing to lend money for business expansion. It has similarly lent money for slum clearance, for rehabilitation of submarginal farmers, and for other broad objectives.

### Exercises and Activities

I Dictionary of Economic Terms

deposit insurance     frozen assets     money market

II Questions and Problems

1) (a) What events indicated the need for a reform of our banking laws in the 1930's? (b) List and explain three ways in which banking laws were revised to increase the security of depositors.

2) Explain the system by which bank deposits are insured.
3) (a) What were the aims of the Banking Acts of 1933 and 1935? (b) What were the main provisions?
4) "The federal government became the most important single factor in our banking system." (a) Explain. (b) List and explain the aims and services of at least three government lending agencies.
5) Explain briefly the functions of each of the following: (a) RFC, (b) FCA, (c) HOLC, (d) FHA, (e) USHA, (f) Export-Import Bank.
6) It has been said that since the 1930's the money center of the country has moved from "Wall Street to Washington." (a) Explain. (b) In your opinion is this a desirable shift? Explain.
7) State arguments for and against making membership in the Federal Reserve System compulsory for all commercial banks.
8) Which agency should have more control over the credit of the nation, the Treasury Department or the Board of Governors of the Federal Reserve System? Give your reasons.
9) (a) Explain the chief reasons for bank failure. (b) Why have bank failures been most common among small banks in rural areas? (c) Why is a high rate of bank failure a problem for the whole nation?

III Things To Do

1) Organize a symposium on "The Proper Role of the Government in the Money Market."
2) Read and report on (a) *Money Changers vs. the New Deal* by Harry Elmer Barnes (Long & Smith). (b) *The Banking Crisis: The End of an Epoch* by Bogen and Nadler, an interesting and simple account. (c) *Other People's Money* by Louis D. Brandeis (Stokes). The late Associate Justice of the United States Supreme Court wrote about the small group of bankers who he claimed dominated the economic life of America. (For advanced students.)

# *UNIT* 9

# NATURAL RESOURCES AND THE FARM PROBLEM


*51* MAN AND LAND

*52* CONSERVATION OF RESOURCES

*53* THE NATURE OF FARMING

*54* THE FARM PROBLEM

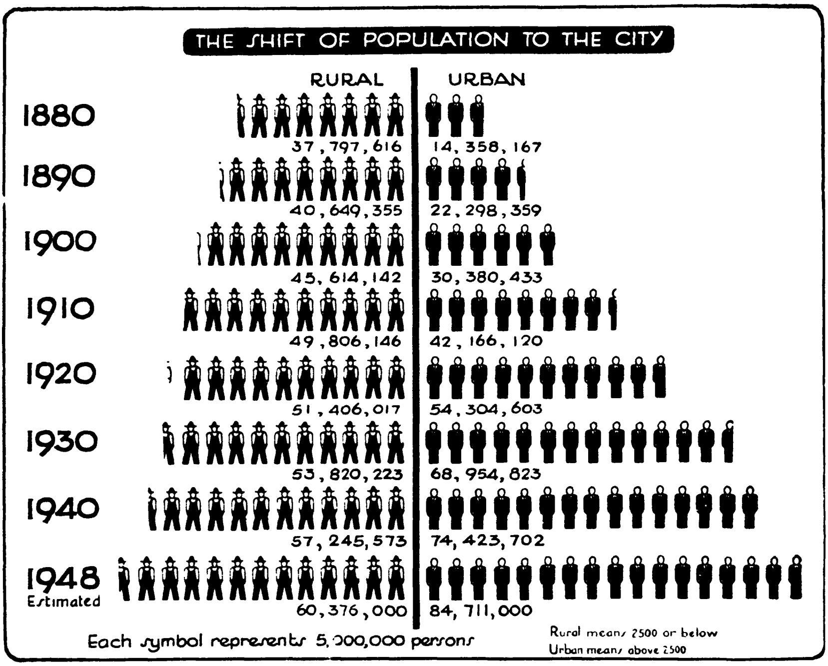
*55* MAINTAINING FARM PRICES AND INCOME

# LESSON 51 MAN AND LAND

## Man and Nature

All recorded history testifies to the reliance of man upon the land. The Biblical story of creation made man the last in the order of creation so that he might have the fruits of the earth to support him. The passage of the children of Israel to the land of Canaan was a search for the promised land "flowing in milk and honey." The mass migrations of ancient times were movements of people from the leaner parts of the earth to the fertile plains and river valleys. The untouched lands and gold mines of the New World drew men as a magnet, despite the hardships of life in a wilderness. In our own country, the "westward movement" to the unsettled frontier was a tremendous factor in shaping our political and economic development.

In the days before the Industrial Revolution, when farming was the chief occupation, most people could easily see that their welfare depended directly upon the land. Today, surrounded by machines and factories, it is easy to forget that modern civilization rests ultimately upon the land and other *natural resources.* A natural resource is a natural factor which man is willing and able to control and put to use. Our foods and most of our clothing are treated products of plants and animals. Artificial and synthetic products depend upon natural raw materials. Rayon is made from wood pulp or cotton linters. Nylon is made from coal, air, and water. Plastics are made from agricultural or mineral raw materials. Our homes are made of wood, steel, brick, stone, or glass —all of them, in their raw state, bounties of nature. From the waters come seafood, sponges, fur-bearing animals, chemicals, fertilizers, and salts. Even insect life gives us honey, shellac, silk, and other products. The very air we breathe yields oxygen, nitrogen, and other gases which man extracts for use in factory products. The waterways make highways for travel. Fall of water from the mountains to sea level is turned into light, heat, and power. This country has been specially blessed by nature. We have level and fertile soils good for farming, timbered slopes good for saw timber, underground pools of oil and deposits of other minerals, and large areas with an invigorating climate. Different combinations of rainfall and temperature support a wide variety of crops. An irregular coastline provides good harbors. Lakes and slopes make for




The industrial revolution stimulated migration to cities by reducing the need for farm labor and by creating job opportunities in cities. (Census Bureau)

outdoor recreation. Nature, however, sometimes presents another face. A large area becomes a distance to travel. Mountains and rivers yield power and transportation, but also create barriers to travel, and may produce floods. Rainfall and sunshine make possible the growing of crops, but an excess of moisture and heat may cause discomfort and disease. Nature can sometimes be an enemy, a force to conquer, rather than a bestower of gifts. In using natural forces, man must be sure not to upset the delicate relationships among natural factors, and thereby unleash the less kindly aspects of nature. Cutting forests and plowing grasslands have removed nature's controls over the run-off of rainfall, and have caused floods, soil waste, and water loss.

The gifts of nature are not evenly distributed over the earth. Much of the earth's surface is too mountainous or too dry to support a settled life based on farming. Therefore there has tended to be a migration of people from rocky hills and deserts to the fertile plains and well-watered river valleys. The thin, rocky soil of New England was an important reason for the migration of many early colonists to the rich, open prairies of the Middle West. In an industrial society, people tend to migrate to places where jobs are available. The presence of resources such as

coal and iron has been a factor in the concentration of population, because our machine industries are dependent upon easy availability of power resources. Great Britain, Western Germany, and the Northeastern part of the United States are regions in which power and iron resources have attracted vast concentrations of population.

The tendency for industries to establish themselves where the conditions are most favorable is referred to as the *localization of industry*. Farming tends to localize where the soil is fertile, while manufacturing industries are established where power, raw materials, and markets are available. Good natural means of transport by way of rivers and oceans has also been a factor in the location of many cities. This availability of transport was what first made New York City a center of population. Climate can be a factor in industry as well as in agriculture. The motion-picture industry found the prevailing dry, sunny weather, plus the wide variety of scenery, important factors in locating in Southern California. The early textile mills located in New England because of the presence of water-power sites and because a damp climate made textile manufacture easier. Florida and other places owe much of their population to the drawing power of climate for recreational purposes.

Natural factors and natural resources, then, are fundamental in explaining the concentration of population. Although custom, personal taste, nearness to markets, and schools also help to explain the location of population and industries, the underlying reason is often some good natural resource.

Nature makes an important contribution to economic opportunity. On the other hand, nature serves mankind only to the extent that man learns to utilize the gifts of nature. For centuries the American Indian possessed the North American continent but failed to develop a commercial and industrial civilization. The white man brought to these shores the accumulated knowledge, skills, and tools of all the previous history of the world. He brought with him, too, the wants and desires for the type of goods and the kind of life to which he had become accustomed. The gifts of nature in the New World became valuable because the white man wanted them and knew how to make use of them. "A man-less universe," says one writer, "is void of resources; for resources are inseparable from man and his wants."[1]

### The Law of Diminishing Returns

Ordinarily, when we talk about land, we refer to the soil upon which we build our homes and factories and upon which we do our farming. In economics, when we discuss land as a factor of production, we mean

[1] Erich Zimmermann, *World Resources and Industries*, Harper & Brothers, 1933, p. 3.

Wanted: A Miracle


Copyright, 1948, New York Herald Tribune Inc.

The Malthusian point of view is expressed in this cartoon. Science may be the "modern miracle" keeping world food supply at a high level.

not only the soil, but also the natural resources which we find on the ground, beneath the ground, in the waters, and in the air. All these vegetable, mineral, and gaseous substances are part of land.

Land is combined with other factors of production, such as labor and capital, to produce goods. The progress of civilization has been based to a large extent on the improvements in methods of applying labor and capital to land. For nature resists the efforts of man to use the land. As

we work the land harder, and try to get a greater yield from a given amount of land—without increasing the efficiency of our methods—we reach a *point of diminishing returns*. This means that, in a given state of technology, as additional units of labor and capital are applied to a given amount of land, a point is reached beyond which the increase in yield (of crops, minerals, or lumber) becomes proportionately smaller than the increase in amount of labor and capital used. Beyond this point, each additional unit produced requires an increasing amount of labor and capital. If, therefore, other land is available, it does not pay to work the farm, mine, or forest beyond the point of diminishing returns. In areas where population is small in relation to the amount of land available, labor and capital will be spread thinly over large amounts of land, in order to avoid the point of diminishing returns. Such methods may cause waste of lands, mines, and forests, but they are the result of the law of diminishing returns.

If additional land is not available and the growth of population makes it necessary to work the land beyond the point of diminishing returns, the cost of production in the extractive industries will increase. The increasing cost of food crops and other raw materials will tend to lower the standard of living of the people.

The principle of diminishing returns is based on the condition that there is no improvement in methods of operation. In the history of our technology, there has of course been continual improvement in methods of farming, mining, and lumbering. The use of machinery and scientific methods has greatly increased the yield of crops, minerals, and lumber per acre of land. Such improvements have made the point of diminishing returns appear later, at higher levels of production, and have contributed to the rise of our standard of living.

### The Malthusian Viewpoint

Over the past 150 years the fact of diminishing returns has caused much concern. At the beginning of the nineteenth century, a famous economist named Robert Malthus wrote a book about the relation of food supply and population. It was his belief that because of the law of diminishing returns, the food supply could not be increased as rapidly as the population was growing. It would be virtually impossible, therefore, for the standard of living to be lifted much above a subsistence level. In recent times similar views have been expressed by writers, sometimes called neo-Malthusians. Thus far, however, the dire predictions of Malthus have not come true in industrialized regions.

The events of the past century-and-a-half have shown that population does not increase indefinitely. As countries have become industrial-

ized and their standards of living have risen, their total population has grown; but the rate of increase of population has generally declined. Improved living conditions and better medical services have cut down the death rate, and the birth rate has declined sharply.

Another important factor is the extraordinary technological progress of the past two centuries, which has made it possible to advance to higher production levels before reaching the point of diminishing returns. Improved machines and methods have increased the yields from our farms, mines, oil wells, and forests. Scientific breeding has given us plants which can better resist insects and drought, and animals which grow faster and are healthier.

Improved seeds, scientific soil analysis, and the development of new and better commercial fertilizers have raised yields per acre in use. Improved processes of manufacture have reduced the waste of raw materials. Refrigeration, speedier transportation and communication, improved storage facilities, all have cut the losses from carrying over surplus crops from year to year. Improved machines of all kinds and extended scientific knowledge about their use have reduced the wastes in the consumption of fuels like coal and oil. Water-power development has offset the scarcity of mineral fuels.

Science and technology have increased the supply of land and other natural resources. Irrigation projects in the Colorado and Columbia valleys, for example, have converted thousands of acres of wasteland into fertile farmland. Modern methods of exploration have uncovered new sources of oil and other minerals.

Artificial and synthetic products made from waste materials have increased our supply of goods; rayon, nylon, plastic, and rubber are cases in point. Today we stand upon the threshold of an atomic age in which the ability to split the atom holds the possibility of a new industrial revolution.

It would be wrong to assume that land, in the economic sense, is no longer scarce, and that the fears of the neo-Malthusians can be lightly dismissed. In some parts of the world the margin between life and death is still a very thin one. The challenge to bring the benefits of the industrial revolution to all corners of the earth still faces us.

## Exercises and Activities

### I Dictionary of Economic Terms

localization of industry
natural resource
point of diminishing returns

## II Questions and Problems

1) Show by examples from your own community that natural conditions affect the way in which people make their living.
2) Show by examples that natural conditions affect people living in cities as well as in rural areas.
3) (a) Explain what is meant by "localization of industry." (b) Give at least two examples of industries whose localization has been decided mainly by natural factors.
4) Explain why uranium ores were not "natural resources" 100 years ago but are today.
5) The dictionary defines "land" as "the solid part of the surface of the earth as distinguished from water. . . ." How does this definition differ from that used in economics?
6) Explain how the fact of diminishing returns helps to explain the following (if possible, give an example in your explanation): (a) why people have migrated, (b) Malthus' theory, (c) the need for conservation.
7) (a) We frequently hear of areas being referred to as "overpopulated" or "underpopulated." Explain what these terms mean. (b) Writers have used the term "the carrying capacity of the land." What does it mean?
8) "The difference between the neo-Malthusians and their opponents boils down to optimism or pessimism about the advancement of science and our ability to apply it." Explain.
9) What relationship is there, if any, between the principle of proportionality (see Lesson 21) and the law of diminishing returns?

## III Things To Do

1) Geography is the subject which traces the relationships between nature and man. Read in any geography text the section on "Geographic Controls" and report to the class.
2) Students of history will find profitable reading in works showing how historical events depend on natural conditions. Examples of briefer works are *Geography and World Power* by James Fairgrieve (Dutton); *An Outline of Political Geography* by J. F. Horrabin (Knopf); and *The Geography Behind History* by G. East (Nelson).
3) Look up and report to the class on the meaning of *geopolitics*.
4) Read and report on (a) *The Road to Survival* by William Vogt (Sloane, 1948). A current and readable presentation of the neo-Malthusian point of view. (b) *Human Breeding and Survival* by G. J. Burch and E. Pendell (Penguin Books, 1947). (c) *Man and Food—the Lost Equation,* Headline Book No. 73 (Foreign Policy Association, 1949). A brief pamphlet. (d) The first two chapters, covering only 19 pages, in *An Essay on the Principle of Population* by T. R. Malthus (Everyman Edition, Dutton). These chapters present Malthusian principles. Advanced readers may be interested in this book.

## *LESSON* 52 CONSERVATION OF RESOURCES

### Factors in the Waste of Resources

At almost regular intervals newspapers and magazines carry warnings that the reserves of this-or-that mineral are being used up, and that in so-many-or-so-many years they will have disappeared. Agricultural soil, we are told, is being washed into the ocean, and the forests are being burned up and chopped down. To some people these predictions are like the cry of "Wolf!" in the fairy tale. They point out that the production of oil is greater than ever, and that the farm problem is surplus, not scarcity. They have confidence in the ability of the scientists to find new sources of power and raw materials to replace those which may become exhausted. But other people remember that in the fairy story the wolf finally did appear, and because the warning fell on deaf ears, he did eat up the sheep!

The chart on page 397 shows the relative exhaustibility of American reserves of minerals. The fuels, because they are needed in manufacturing and transportation, are of particular importance.

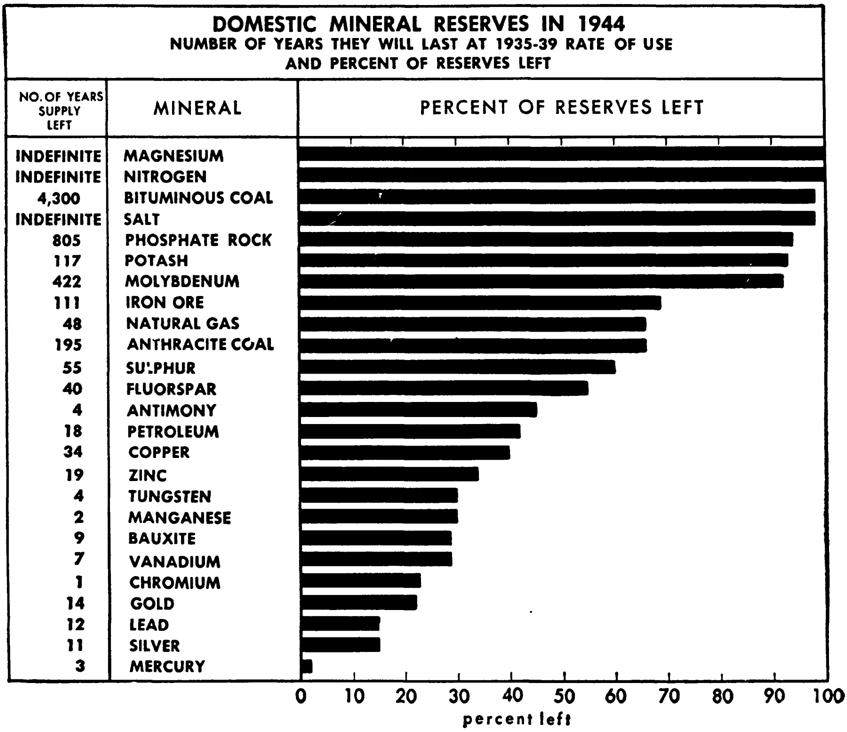
The intelligent use of resources means slowing up the rate at which the scarcest resources are being used, by substituting the use of the more abundant ones. Thus one value of developing water-power resources lies in the fact that they will slow up the rate at which coal and oil will be used.

Another factor which influences the waste of resources is the method used in extraction. Vast amounts of fertile soil have been ruined because of careless farming practices. Millions of tons of coal have been wasted by fires, by flooding, and by incomplete working of valuable veins. Billions of cubic feet of natural gas have been permitted to blow off into the air. Lumber companies have often unnecessarily stripped the forests. This waste in the extractive industries has been greatest where conditions of cutthroat competition have encouraged the process of "skimming the cream." Careful methods of extraction cost money. When selling prices are low, farmers, miners, and lumberers are likely to skimp on conservation practices.

A third factor is the method used in processing the product which is extracted. Faulty methods of manufacturing, inefficient machines, and backward technology cause waste of resources. The ancient boiler takes more coal than the boiler with higher fuel efficiency. Many factories throw away valuable waste products. George Washington Carver, working with the lowly peanut, demonstrated what could be done with waste materials formerly considered useless.

A fourth factor is the twin factor of optimism and ignorance. A lack

of worry about the future, and a selfish consideration only for the present, are contrary to wise resource use. Ignorance leads to poor resource use, to poor methods of extraction, and to inefficient methods of processing. Above all is its accompaniment of wanton carelessness; for example, the flicked cigarette, or the spark from the unguarded fire, that sets off the forest fire or mine explosion.




Estimates of mineral reserves and their length of life have frequently been in error. Nevertheless, the need for conservation of strategic minerals is apparent from the table. (Data from *The Index*, N.Y. Bank and Trust Co., Winter, 1946)

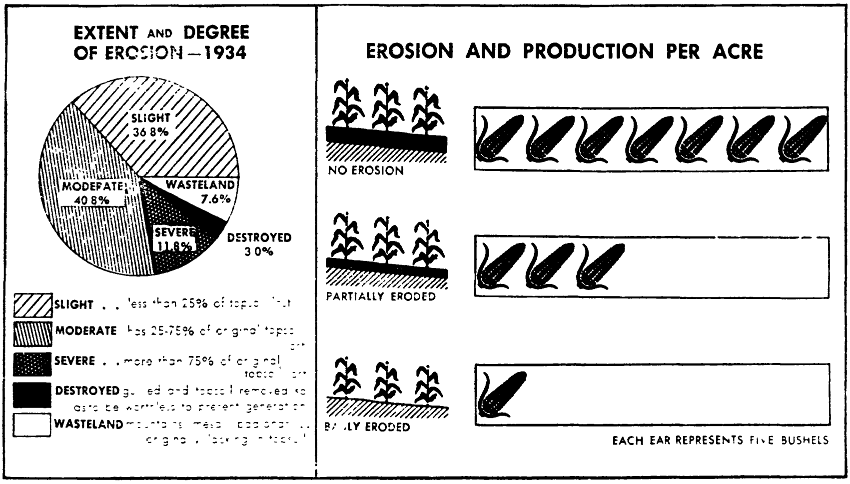
A fifth factor has been an excessive rate of use of resources because of wars. The rate of production of farms and mines has had to be speeded up to produce materials of destruction, thus speeding up the rate of resource use. Worst of all, wars have directly destroyed the farm lands, forests, and mines of many countries.

### Soil Exhaustion and Erosion

The damage to this country's soil has indeed been frightening. Much of the nation's topsoil has been washed into the sea, and the poorer soil

left behind yields a smaller crop for a given amount of effort. The facts about soil damage are stated in the chart below.

Soil, the source from which plants draw food and water, may be destroyed by two general processes. The first process leaves the soil intact, but removes essential plant foods, or nutrients; this is *soil exhaustion*. Every time a crop is harvested or land is used for grazing, the soil loses some of its chemical elements. If the chemicals are not restored through




The graph on the left reveals that by 1934 soil erosion had made serious inroads upon soil fertility. (Data from *Yearbook of Agriculture*, 1938). The effect on crop yields is shown in the graph at the right. Erosion of soil means reduction of the food supply. (*Little Waters*, Soil Conservation Service)

the application of fertilizers, or through the planting of crops that restore the chemical elements, the soil eventually becomes exhausted. This occurs especially in a system of *one-crop agriculture;* planting the same crop year after year hastens the loss of plant foods. This is the reason for the large amount of worn-out soil which is to be found in the Southeastern part of this country. Soil exhaustion can be largely prevented, not only through the use of fertilizers, but also through *crop rotation*. This means that chemical-restoring crops, such as legumes, alfalfa, and beans, are alternated with the regular crops, so that the vital chemicals are restored to the earth.

Soil exhaustion also results from *leaching*, which is the dissolving and washing downward of the minerals to the subsoil, beyond the reach of the roots of the growing plants. Leaching is always taking place, but it is hastened by excessive rain, and by deep plowing which makes the flow of water easier. It is because of leaching that the rainiest portions

of the earth, like the Amazon Valley, are generally those with the poorest soils.

The second process by which soil is spoiled is more drastic and dangerous than soil exhaustion, which at least leaves the soil intact and capable of being improved. Soil *erosion* is the actual removal of topsoil, by its being washed or blown away. When the natural vegetation, trees or grass, is removed by farmers, and the land is plowed, the fine particles

*Soil Conservation Service, photo by Oliver*

**Corn cultivation leaves sloping soil open to erosion. The slope in this field was about 20%. Notice the complete absence of binding soil cover between the rows of corn and the silt and sand deposited, to a depth of 8 to 15 inches, at the base of the slope.**

of soil are exposed to rain and wind, and the process of erosion is speeded up. In rainy areas the rain washes the soil into brooks, rivers, and on to the sea. As the topsoil is carried away, rain cuts gullies into the subsoil and leaves it unfit for any use.

In drier areas the wind blows off the fine topsoil and deposits it as silt in wells, lakes, and reservoirs, or drops it as a sandy cover over good farm lands. Once land is eroded, the natural protection against floods is removed. The fall and flow of water is not retarded by leaves, grass, or roots, and the run-off to the river is hastened.

Various methods for preventing erosion have been developed. Where

the slope is too great, or land has already been eroded too far, replacing the natural vegetation—trees (*reforestation*) or grass—may be needed. Farmers are being urged to plant trees and grasses on steep slopes as a means of checking the flow of water. Cover crops, such as alfalfa and clover, not only make good pasture, but restore minerals to the soil, and also bind the soil in such a way as to prevent erosion. Where farming is

*Photo by Lowary*

Alternate strips of close-growing crops and cultivated crops help to retain the topsoil and retard erosion. Note, too, that the plowing and planting followed the contour.

being done on hilly land, the farmer can check erosion by the use of *contour plowing,* that is, by planting the crops in lines which go more or less horizontally around the slope, instead of in straight lines up and down the slope. The horizontal ridges resulting from contour plowing check the downward flow of water. Where gullies already exist as a result of erosion, small "check-dams" can be used to hold up the water, or the gullies can be filled and reclaimed for cultivation. Wind erosion can be lessened by planting rows of trees as windbreaks.

### Saving the Forests

The cry of "Timber!" has been closely associated with the progress of the American people across the continent. In the days of the pioneer, the forest was a barrier which had to be removed by cutting and burning to make room for farms and cities. Now the forest has become a

vanishing resource. The original 900 million acres of forest have been reduced by more than half, and much of what is left is of inferior quality.

Until recent years the American lumbering industry was regarded as one of the most wasteful industries in the country..The supply of lumber seemed so great that little thought was given to the future. Only the best trees were cut for lumber, with the result that much of the forest was allowed to go to waste. Trees were cut well above the ground, and valuable lumber was left in the stumps. There was no large-scale, systematic planting of seed trees to provide new forests for the future. Unused stumps and branches were left in haphazard fashion, making a fire hazard. Cut forests were used as grazing lands; when the animals had consumed the vegetation, conditions were ripe for floods and soil erosion. To a large extent, those wasteful practices resulted from the pressure of competition and the efforts to keep costs low.

Not all the blame for the disappearance of lumber resources can be placed on the lumber companies. Forest fires destroy huge amounts of timber every year, in addition to fish and game. Another danger is the variety of tree pests, which in a few years can wipe out large quantities of a particular kind of tree.

It is hardly necessary to point out the reasons for concern about the rapid destruction of our forests. Lumber has been important as a fuel, as a building material, as the raw material for paper, and as a source of many chemical products. The growing scarcity of good lumber has increased the cost of housing, furniture, wooden boxes, paper, and many other articles. Forests also help to control the flow of water, thereby preventing floods and soil erosion. They help to preserve wild life, and bring recreation and beauty into the lives of many people.

During the past few generations there has been a belated attempt to save the American forests. The federal government—likewise, a number of state governments—have developed a Forest Service, which maintains a fire patrol, protects wild life, and studies methods of preventing insect damage to trees. Some of the lumber companies have adopted *sustained-yield forestry,* which means planning the cutting of ripe trees and the planting of seed trees in order to maintain a permanent lumber reserve. The government has begun a program of reforestation, or planting new forests on public lands. Meanwhile, the dependence on lumber is being reduced by the increased use of substitutes for wood, such as lightweight metals and plastics.

### The Conservation Movement

In this country, so rich in its heritage of untouched resources, it was natural that the land and other natural resources should be wastefully used. Early land policy was directed toward disposing of the public

lands in such a way as to encourage their settlement and exploitation. Only since 1890 has *conservation of resources*—planned use and replacement of resources—become our policy. A law providing for the setting aside of forest preserves (1891) was the first concrete evidence of this policy. The Forest Service was established to guard the public forests. President Theodore Roosevelt extended the program and gave it the publicity and prestige needed to engrave it on the public mind as a national necessity. The Newlands Act of 1902 provided funds for the construction of irrigation dams to increase the amount of usable farm land. Laws were passed in later years to regulate the sale and use of public lands, containing mineral and lumber reserves.

In the 1930's the conservation movement was carried much further. The crop-control system became an instrument for spreading soil-conservation practices. The Soil Conservation Service was organized to demonstrate and initiate conservation projects among the farmers, especially projects for limiting soil erosion. Through the Civilian Conservation Corps, thousands of unemployed young men were put to work planting seed trees, building dams, and in other ways furthering the program for controlling floods and erosion. Laws were passed to tighten federal control of grazing on public lands in the West. Large sums of money were voted for the building of dams and levees to reduce flood damage.

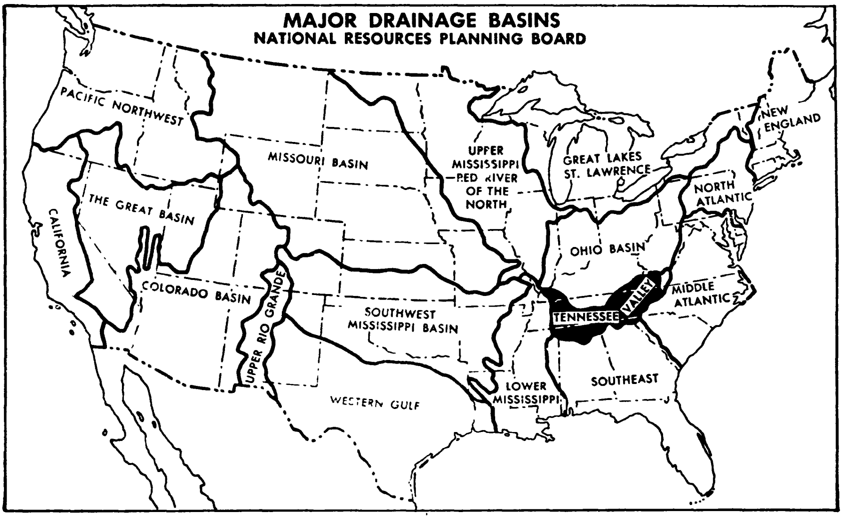
### TVA and Regional Planning

The valley of the Tennessee River includes over 40,000 square miles in seven states. It is part of the Ohio River Valley, because the Tennessee finally flows into the Ohio; and it is part of the Mississippi River Valley, because the Ohio is a tributary of that river. The entire country can be divided into major drainage basins surrounding the rivers that flow into the sea, and into subdivisions based on their tributaries. Some of these drainage basins have been referred to as possible areas where organized planning might be begun—the valleys of the Missouri, Colorado, Columbia, and St. Lawrence Rivers. The river valley, or drainage basin, becomes a unit of resource planning, because the flow of water is a more natural basis for such planning than state or other artificial boundaries.

The Tennessee Valley Authority (TVA) is a federal corporation charged with the development of the Tennessee River. It is managed by a Board of Directors consisting of three persons chosen by the president, with the advice and consent of the Senate.

The Tennessee Valley Authority has the responsibility, first, of keeping the Tennessee River open for navigation, by maintaining a channel nine feet deep. This means storing up excess flow in the rainy season and releasing it during the dry part of the year. To do this, a number of

dams have been built along the Tennessee River and its tributaries. These dams create huge storage reservoirs or lakes, which are available for recreational purposes. The falling water can be used for the generation of electric power. Controlling the depth of the channel of the Tennessee is also a measure of flood control, for it holds back the waters during the flood season, and releases them when the danger is over. Controlling the flow of water also involves reforestation, contour plow-




The one drainage basin where the most complete resource planning has taken place, the Tennessee Valley, is shown in black. The map shows further potentialities for resource planning by indicating a division of the country into drainage basins which could serve as planning areas. (Map from National Resources Planning Board)

ing, and other measures which help to reduce soil erosion. Farmers in the valley have been taught proper methods of farming, so that they can coöperate in accomplishing the goals of the project. Thus, the TVA has become a coördinated project for control of the land and water resources of the entire Tennessee Valley. Furthermore, it has become a project for improving the working methods of the people in the valley and for raising their standard of living.

A problem of major proportions arose over the sale of the electric power produced. Private utility companies objected to the direct sale of power by the TVA to municipalities. They argued that this would be unfair competition for the private companies because the TVA could charge part of its costs to navigation and flood control, rather than to power production. Moreover, the TVA did not have to pay taxes. Opposition also arose on the ground that government ownership and plan-

ning represented a socialistic experiment, contrary to freedom of enterprise.

The TVA finally purchased the properties of the largest utility chain in the region. Today it is serving municipalities and private companies alike with cheap electric power. Its costs and rates serve as a sort of yardstick to check the reasonableness of private rates. The use of electricity by the people, farmers, and industries of the Tennessee Valley has increased tremendously. During World War II, government plants for the manufacture of vitally needed materials were built in the Tennessee River region and the valley became an outstanding area in production. This growth of economic opportunity has raised the living standards of the people in the valley. In the fifteen years after the start of the TVA project, living standards rose over 200 percent, twice as much as for the nation as a whole.

Not only has the TVA resulted in the improvement of economic conditions in the wide area it affects, but it has become a huge demonstration project in methods of erosion control and reforestation. Cheap power has permitted the exploitation of local phosphate resources to supply the fertilizer needed by the soils of the region. New forests have been planted, giving promise of timber production on a sustained-yield basis. Part of the program of erosion control involves substituting orchard or tree crops for plowed crops, and will result in a harvest of nuts and fruits. The eroded hillsides have been turned into usable pasture for dairy cows, adding income for the farmer.

This type of regional planning for resource use may be the basic conservational measure for the future. Hoover Dam, providing irrigation for the dry lands of the Southwest as well as power, is a federal project on the Colorado River. Grand Coulee Dam, on the Columbia River, will help reclaim the dry areas of the Columbia River Valley; while the Bonneville Dam, on the lower reaches of the Columbia, is primarily a power producer. Plans have been discussed for a giant project in the Missouri River Valley, to provide flood control, power production, and irrigation. Similar development of the Ohio River Valley and the Mississippi River Valley might help to control the devastating Mississippi floods.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| crop rotation | leaching | soil exhaustion |
| conservation of resources | one-crop agriculture | soil erosion |
| contour plowing | reforestation | sustained yield forestry |

## II Questions and Problems

1) Tell how each of the following is related to land use and resource conservation: (a) one-crop agriculture, (b) exhaustible and inexhaustible resources, (c) fertilizer, (d) run-off.
2) (a) Explain how the T.V.A. came to be a "coordinated project in resource conservation." (b) How does it illustrate "multiple use of water resources"?
3) Our most exhaustible and irreplaceable resources seem to be minerals, and among these the most crucial seem to be fuels or power resources. Explain why this is a fact of particular significance to a highly industrialized nation like the United States.
4) Explain the effect of each of the following on the supply of natural resources: (a) one-crop specialization in farming; (b) extremely low earnings and income among farmers; (c) a very high proportion of small, tenant farms; (d) cutthroat competition in oil production or other mineral industry; (e) heavy taxes on uncut timber lands; (f) exceptionally heavy rainfall over newly plowed lands; (g) rapid cutting of timbered hillsides.
5) Explain how each of the following may be partly responsible for resource waste: (a) the consumer, (b) the miner, (c) the farmer, (d) the manufacturer, (e) the government.

6) Estimated Reserves of Seven Important Minerals

PERCENT OF TOTAL WORLD RESERVES

| *Area* | *Coal* | *Iron Ore* | *Petroleum* | *Copper* | *Bauxite (Aluminum)* | *Zinc* | *Lead* |
|---|---|---|---|---|---|---|---|
| United States | 45 | 34 | 35 | 22 | 3 | 34 | 35 |
| U.S.S.R. | 27 | 11 | 14 | 16 | 3 | 12 | 2 |
| British Empire (incl. Canada) | 11 | 23 | 1 | 26 | 31 | 26 | 45 |
| Other | 17 | 32 | 50 | 36 | 63 | 28 | 18 |

The source (National Industrial Conference Board) states that the figures are the "latest available (1947) and reflect the postwar situation so far as ascertainable."

(a) Explain why figures such as these are so easily subject to error.
(b) From the data given, how do the three great powers compare?
(c) With such great reserves, why is the United States nevertheless a great importer of some of these minerals?

## III Things To Do

1) Read (a) *Saving Our Soil* by Maxwell S. Stewart (Public Affairs Pamphlet No. 14, 1937). This pamphlet summarizes the extent of soil erosion, the causes, and the methods of approach. (b) *Little Waters* by H. S. Person (Soil Conservation Service, 1935). This pamphlet explains in readable fashion, with many illustrations, the prin-

ciples of proper land and water use. It incorporates the ideas set forth in the documentary film, *The River*. (c) *The Tragedy of Waste* by Stuart Chase (Macmillan, 1925). One of the oldest and still one of the best works setting forth the various causes of waste. Chapter XII is most relevant. (d) *Our Plundered Planet* by Fairfield Osborn (Little, Brown, 1948) is an up-to-date popular treatment of the need for conservation. (e) *Rich Land, Poor Land* by Stuart Chase (McGraw-Hill, 1936).

2) Write to the Agricultural Experiment Station in your state and find out what work in conservation is being carried on there.
3) Prepare a graph showing the facts in the table in question 6.

# *LESSON* 53 THE NATURE OF FARMING

FARMING: A WAY OF LIFE

"The city is a fine place to visit but I wouldn't want to live there," says the tourist from the country. "Great for a vacation, but how can you stand it all year long?" asks the city dweller of the dweller on the farm. Each has his accustomed mode or pattern of living, and to each the other's way of life seems strange.

The city worker or businessman leaves his home each morning to go to work. The income secured from the job or business helps to determine what kind of living standard the family can have. But, otherwise, there is usually no direct connection between working life and family life. The farmer's working life and family life are closely joined. The farm is both home and a place of work. All the members of the family are likely to share in the daily chores. Only one-fifth of the workers on American farms are hired hands. The bulk of the farm work is done by the farm operator and his family. Despite some growth of large-scale farm enterprises, the typical American farm is the *family farm*, combining farming and living.

Farming is not an easy way of life. In 1936 the hours worked by farm operators averaged from ten to twelve hours per day during spring, summer, and fall, and somewhat fewer in the winter. Even Sunday, the day of rest, requires a few hours for milking or other essential chores. The city worker is apt to be more of a specialist in his work; the independent farmer must be a jack-of-all-trades. He must know how to care for animals, how to choose his fields for planting, which crops to plant, when to plant them, when to water, dust, spray, cultivate, fertilize, harvest. He must know how to ship his crop, where to ship it and when. He must deal with buyers of crops, sellers of equipment, lenders of

money. He must have some familiarity with tools and electrical equipment; he must be able to tinker with a tractor motor, fix the water pump, patch the roof, paint the barn, and do other odd jobs.

Although there are many prosperous farmers, standards of living among farmers have been lower, on the average, than standards of city families (see Lesson 11). Many farm homes lack what city dwellers consider elementary comforts. In the 1930's over 80 percent of our farms had no running water piped into the home; about two-thirds had no telephone; four-fifths had no radio, and relatively few had electricity in the home. A notable job has been done by the Rural Electrification Administration (REA), a federal agency organized as part of the depression program of rural rehabilitation, to help farmers secure the use of electric power. By 1947, the proportion of farms which were electrified had risen to almost 50 percent of the total. Despite the improvements resulting from the work of the REA and from wartime prosperity, it has been estimated that two-thirds of our farms are still in need of modernization and improvement.

Certain groups of farmers have had especially low incomes and living standards. One example has been the farm worker or hired hand, whose wages have been much lower than the wages of the average factory worker. The *migratory farm worker,* without fixed home, following the harvest with each changing season, has been at the lowest level of all. Another group has consisted of the sharecroppers of the South. A third group has been families eking out a living from submarginal lands: lands which require excessive effort and yield substandard income. The reasons may be leaching, erosion, exhaustion, or other deficiency.

Although farm poverty has not been abolished, these rural-slum conditions have been improved. A federal agency created for that purpose, the Farm Security Administration (FSA), until its abolition in 1940, did much to raise rural living standards. Improved housing, resettlement of farmers from submarginal lands, camps and educational facilities for migratory workers, and loans to tenants for buying land were parts of its responsibility. A second factor contributing to improvement has been the general program to raise farm prices and incomes, which will be discussed in a later lesson. Probably of greatest importance has been the improved market for farm products which resulted from the war.

## Farming: A Land-Using Business

In 1946, farm assets were worth over 101 billion dollars. They were composed of the following:[1]

[1] U.S. Bureau of Agricultural Economics, U.S. Department of Agriculture, presented graphically in *Road Map of Industry No. 600*, National Industrial Conference Board, June 1947.

| | |
|---|---|
| Land | 55.7 percent |
| Livestock | 9.5 |
| Machinery and Equipment | 4.7 |
| Crops | 6.0 |
| Currency and Deposits | 13.8 |
| U.S. Savings Bonds | 5.0 |
| Household Equipment | 4.3 |
| Other | 1.0 |
| | 100.0 percent |

Land is obviously the farmer's chief asset. Of our total land area of almost two billion acres,[2] from one-half to two-thirds is land in farms. The bulk of the remainder, as is shown in the diagram on page 409, consists of grazing and forest lands and land which cannot be used for crops.

Like the businessman, the farmer must combine his land, labor, and capital in proper proportions, according to their relative cost. If land is scarce and expensive, whereas labor is cheap, it will pay to use more labor. It will be a desirable proportioning because it will secure the greatest output per unit of land. Using a great deal of cheap labor on a relatively small quantity of expensive land is called *intensive farming.* It is typical of countries where population is high and land is scarce, such as Belgium, and other crowded countries of Western Europe. If land is relatively plentiful and cheap, while labor is scarce and wages high, it will pay to use more land and less labor. In order to accomplish this, it is necessary to use machines and capital equipment of various sorts to do the work. Spreading labor and capital over a relatively large amount of land is called *extensive farming.* It is typical of newly settled countries, where more land is available, and labor supply is less plentiful; as in the United States, Canada, and Australia. Extensive farming gives a low yield per acre, compared to intensive farming, but a greater yield per man employed. In both cases the aim is to make the scarcest factor yield the most.

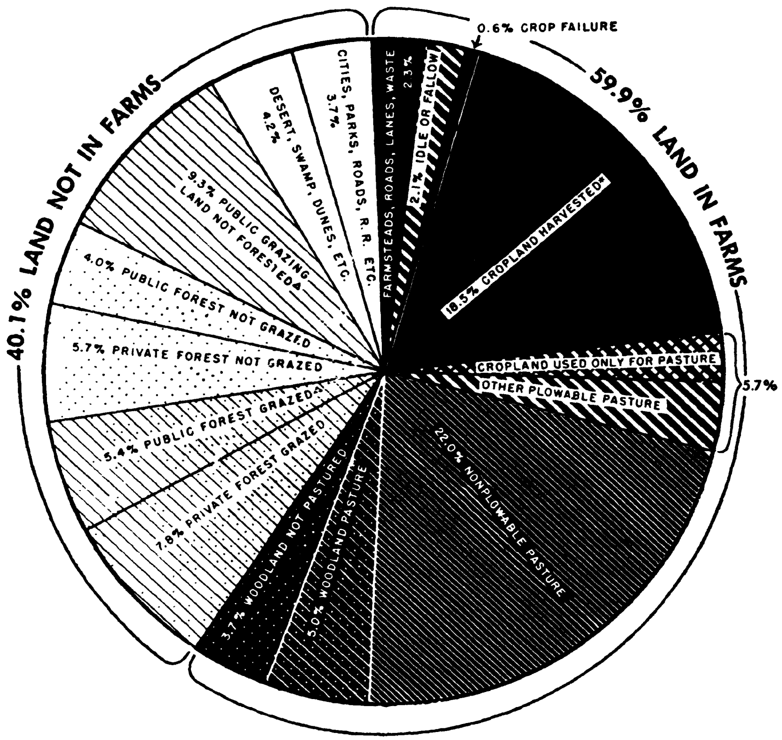
### Diversification and Specialization

Most farming involves the production of more than one crop, for a number of reasons. When several different crops are raised on the same farm, there is *diversification of crops.*

Diversification may result from using crop rotation to prevent soil exhaustion. Another reason may be the varied nature of the land mak-

[2] City dwellers may need help in visualizing an acre. There are 640 acres to the square mile, and an acre therefore contains 43,560 square feet. An acre is slightly more than the area contained in a square plot about 200 feet by 200 feet. If a building lot in your city is 20 x 100, an acre would permit the construction of about 21 homes on building lots of that size.

# MAJOR USES OF LAND IN THE UNITED STATES—1945




*PERCENTAGES SHOWN IN LARGE CIRCLE ARE OF TOTAL LAND AREA OF THE NATION*

* *CROPLAND ACREAGES ARE FOR 1944*

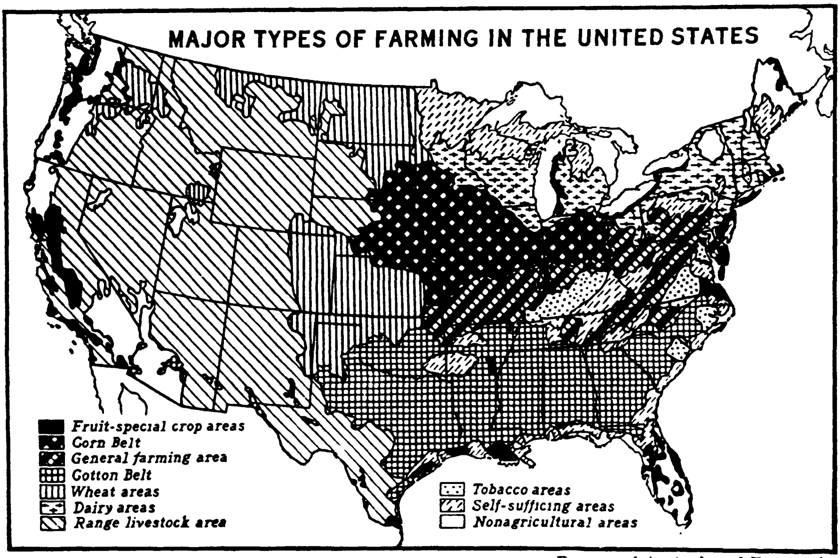
♠ *ADDITIONAL PUBLIC GRAZING AND FOREST LANDS ARE INCLUDED IN THE LAND REPORTED IN FARMS*

About 60% of the area of the United States is in farms and about 40% is in forest, grazing, or land otherwise useless for farming. Less than half the farm land is used for crops or can probably be so used; the rest is mainly woodland, nonplowable pasture, roads. (U.S. Dept. of Agriculture)

ing up the farm. The farmer may use his level, valley-bottom land for grain, the sandy soils for a root crop, the hillside for pasture and a crop of hay. Poultry and egg production is a cash-producing sideline on many farms. Much diversification, however, is the result of a deliberate avoidance by the farmer of the risk of investing all his labor and energy in a single crop, which may fail to bring a satisfactory market price.

Despite the fact that there is a great deal of diversification, there is also a tendency to specialize on one crop to bring in a money income. Crops which are produced for sale are called *cash crops*, and farms which produce the bulk of the crops for sale in the market are called

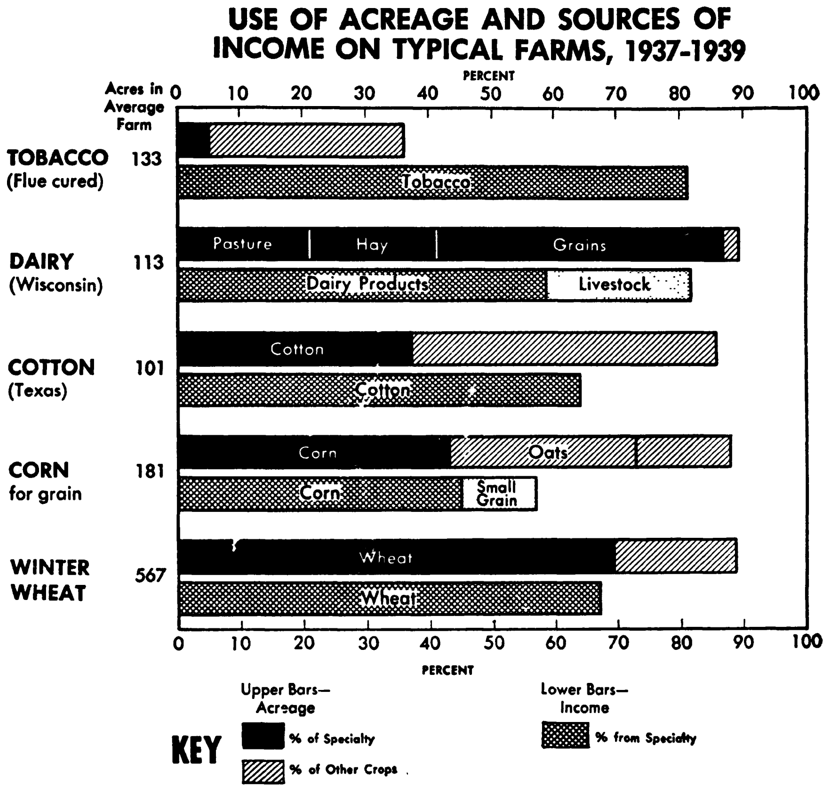
*commercial farms.* Farms which produce only a small proportion for sale and the bulk of their crops for direct use by the family are called *subsistence farms.* In the 1930's about one-eighth of all farm production was consumed on the farm by farm families; the goods thus used are called "income-in-kind." About seven-eighths was sold for cash, and produced a cash income. This fact indicates that most American farming is commercial farming. The map above indicates the chief regions of farm specialization in the United States.



*Bureau of Agricultural Economics*

Natural and economic factors together determine areas of crop specialization. In each area, however, other farm products are produced.

Specialization results from economic factors as well as from natural factors. The farmer tends to specialize in that product which is likely to yield him the best return in the market. Southern farmers may be able to grow corn, which could compete with the corn of Iowa. However, they can also grow cotton, which the farmers of the North cannot produce at all. It pays them better to specialize in cotton, the crop for which they have the greatest advantage, and leave corn growing to the Iowa farmer. Farmers in Southern California, producing under conditions of irrigation, could grow superb crops of wheat. It pays them better, however, to produce truck crops and fruits, which can fill the Eastern markets during the winter season. This type of specialization is often referred to as "the principle of comparative advantage." The chart on the opposite page shows the degree of specialization and diversification on typical farms in several different farming areas.




The average-size tobacco farm was 133 acres. Only 36% of this acreage was cultivated at all (top bar), and only about 5% was used for tobacco, the crop specialty. Yet over 80% of the cash income (bottom bar) came from sales of tobacco. In the case of other crops, a larger proportion of acreage was used, and a smaller percentage of cash income came from the one specialty. (Data from *Agricultural Situation,* U.S. Dept. of Agriculture, selected issues, 1941–42)

A further reason explaining specialization is the factor of custom. As new crop possibilities develop, or as market conditions change, it may be hard to convince farmers to shift to a new crop. For many years farmers in the South persisted in planting cotton, although cotton prices were falling, and one-crop cotton culture was ruining the soil. There is among farmers the same kind of immobility that is found among businessmen and workers.

### Farm Tenancy

The farmer's ownership of his farm is an American institution. Two-thirds of this country's farms are operated by their owners, or independent farmers. This is a higher percentage than in most other coun-

tries, and is explained by the large amount of free land which was available in the United States in the nineteenth century. In recent times, however, there has been a growth in the number of *tenant farmers,* who rent their farms from landowners. In 1945, 30 percent of American farms were operated by tenants. This represented a sharp decline, however, from 42 percent in the 1930's, when many farmers had lost the ownership of their farms, and had become tenants. But wartime prosperity enabled many tenant farmers to buy farms. Many tenant farmers took jobs in the factories and shipyards, and left the farms to be operated by the owners. Government loans have also made it easier for tenants to buy land.

Often the tenant farmer pays the landowner a fixed rent in cash. Sometimes—and this is particularly true in the cotton-growing regions—the rental contract may provide for the rent to be paid in kind, out of the crop raised by the tenant. Tenants who pay rent in the form of a share of the crop are called *sharecroppers.* The contract usually calls upon the landlord to provide the tenant with land, living quarters, seed, equipment, and perhaps a mule. The more the landlord provides, the larger the share of the crop which must be paid to the landlord by the tenant. The rental charge may be from one-third to two-thirds of the crop. In effect the sharecropper is little different from a hired hand; but whereas the hired hand gets a definite wage, the sharecropper's gains depend upon weather and market conditions.

Some tenant farmers are as well off as independent farmers, or better off. To a large extent, however, farm tenancy has been associated with poverty. This has been particularly true in the case of the Southern sharecroppers. Especially in periods of low farm prices, sharecroppers often owe more at the end of a season than they can realize from their share of the crop, and need credit to get through the winter and start the next season's planting. The living standards of sharecroppers in the South have been close to the lowest in this country.

Farm tenancy is a problem also because it tends to block the use of soil-conservation methods. The tenant farmer is interested in making as much out of his farm as possible, and does not worry about preserving the fertility of the soil for the future. He is unlikely, therefore, to rotate his crops or to invest in soil-conserving improvements, unless some inducement to do so is given him by the landlord or the government.

### Farm Debt

Throughout American history, farming and debt have gone together, because American farming has been based on the ownership of land. Land is a fairly expensive commodity, and is not usually paid for fully in cash. Most buyers borrow money to provide part of the capital

needed. They are able to borrow easily on land purchases because, by means of a mortgage, they are able to give the land as security. Loans secured by mortgages on real estate run for long periods of time, as long as twenty or twenty-five years. When we speak of the farmer's need for long-term credit, we are referring chiefly to loans based on mortgages on farm lands and buildings. High interest rates have been a common cause for complaint by farmers. In 1916 and 1923, an extensive system of government-supported banks was organized to meet farm needs for credit. These banks were coördinated in the 1930's under the Farm Credit Administration (FCA).

When farm prices and incomes are rising, there is a tendency for the price of farm land to rise. The farmer thus has a double opportunity to profit from rises in the prices of the products he produces. His income rises, and the price he can receive for his land—if he wishes to sell his farm—also rises. By the same token, shrinking farm prices double his possible losses, as his income drops, and his land shrinks in value.

Throughout American history, countless numbers of farmers have had the unfortunate experience of trying to maintain high-cost farms out of shrunken incomes. In most periods of rising prices of farm products, farmers have expanded their debts, in order to buy more land, put up new buildings, and buy machinery and equipment. The result in such cases is an increase of the total amount of debt and of the interest and installment payments. At the same time, the taxes on the farm are likely to go up, because of the higher value of the farm. Hence, a period of high prices for farm products tends to bring about a rise in the overhead costs of farm production.

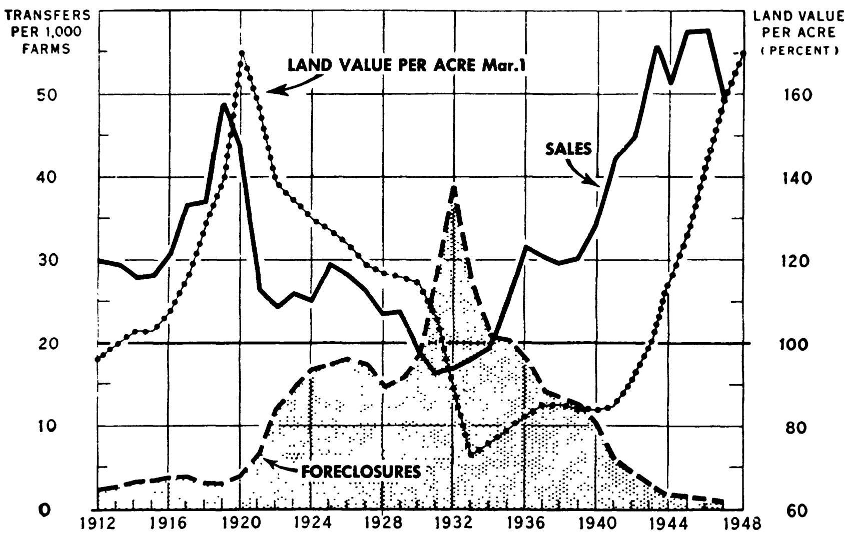
As long as the prices of farm products remain high, farmers' incomes are large enough to meet the increased expenses. When these prices drop, it becomes increasingly difficult for farmers to make the required payments to the banks and farm-machinery firms. When the situation becomes acute, the banks and other creditors may find it advisable to foreclose the mortgages they hold, and take possession of the farms in order to collect their loans.

The chart on page 414 shows changes in land values during periods of rising and falling prices. It will be observed that the number of foreclosures was greatest when land values were shrinking most. During World War I, the rise in farm prices caused an overexpansion in farming, in land values, and in farm debt. After the war, the drop in demand and decline of prices brought with it a shrinkage in land values and a rise in the number of foreclosures.

By 1933, the situation had reached the proportions of a crisis. As part of the New Deal program, a *moratorium,* or legislative postponement of mortgage payments, was declared. The Farm Credit Administration

was established to coördinate the various federal agencies granting farm credit, and to liberalize credit terms. It reduced the mortgage debt of thousands of farmers. It offered banks, insurance companies, and other holders of farm mortgages, government bonds in place of the mortgages. The mortgagees were glad to exchange the mortgages for secure government bonds. The FCA then reduced the principal and interest on the mortgages it had taken over, thus lightening the financial burden of the farmers.

**LAND VALUES, NUMBER OF SALES, AND FORECLOSURES, 1912-1944**




The line showing number of sales and the line showing land values go up and down together. Rising land values are a response to rising prices of farm products. On the other hand, foreclosures are heaviest when land values are lowest. Low prices of farm products bring low land values and inability to meet mortgage interest and payments. (Data from U.S. Dept. of Agriculture)

During World War II, when there was a notable rise of farm prices, farm debt declined, contrary to the usual tendency. One reason for this peculiar development was the scarcity of farms and farm equipment available for purchase during the war. As a result, American farmers were in a much sounder financial position after World War II than they had been after World War I.

## Hazards of Farming

Farming as a business, using land as its chief asset, runs the risks of the ordinary business, plus additional risks resulting from nature. Too

much rain or too little rain, too low a temperature during the growing season or too high a temperature before the growing season, windstorm, hailstorm, dust storm, insect pest, plant disease or blight—any of these may ruin the crop and the farmer. He can do much to avoid such losses by scientific methods of cultivation, proper seed selection, use of fertilizers, and so forth. But technology has not yet reached the point of eliminating completely the many natural hazards he has to face. Against some types of loss, hailstorm for example, the farmer may buy insurance from private insurance companies. A limited and experimental government program of crop insurance was introduced as part of farm legislation of 1938 (Agricultural Adjustment Act). Yet the problem of loss from natural causes is still a large one.

Even when nature is favorable to the farmer and he raises a bumper crop, he has to face the uncertainties which face any businessman with a product to sell. When the farmer plants his crop, he has no assurance of what price it will bring when it is harvested. His income depends upon the prices which he receives for his crop. Furthermore, like any other businessman, the farmer has expenses which must be met out of his income. To understand the economic problem of the farmer, it is important to understand the nature of his expenses and the nature of the market in which his income is determined.

### Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| cash crop | family farm | sharecropper |
| commercial farm | intensive farming | submarginal land |
| crop diversification | migratory farm worker | subsistence farm |
| extensive farming | moratorium | tenant farmer |

II Questions and Problems

1) Identify the following: (a) Farm Credit Administration, (b) crop insurance.
2) "Under intensive farming yield per acre is high and yield per man is low. Under extensive farming yield per man is high and yield per acre is low." Explain.
3) State and explain two factors which tend to make for specialization in farm production.
4) State and explain two factors which tend to make for diversification in farm production.
5) (a) List three natural hazards faced by most American farmers. (b) Suggest one way in which the farmer tries to protect himself or is assisted in protecting himself from loss through such events.
6) Study the map on page 410. Make a list of ten agricultural products

used by your family regularly and locate the region from which each comes.

7) The Report of the President's Committee on Farm Tenancy (1937) referred to the effects of farm tenancy as causing "erosion of soil and the erosion of our society." Explain.
8) "Recurring depressions rank high in any list of forces stimulating the growth of farm tenancy." (a) Explain. (b) List other forces that stimulate the growth of tenancy.

III Things To Do

1) Read (a) *U.S.A.: Measure of a Nation* (Twentieth Century Fund 1949), Chapter 20. (b) *Farming in America* by Harold S. Sloan (Harper, 1947), especially Chapter I. (c) *Modern Farming* by Roberts, Angerer, Moses, and Gregory (Lippincott, 1950), a textbook for high school courses in general agriculture. City students particularly will profit from looking through the problems in this or other texts on farming. (d) Selected portions of the 1940 *Yearbook of Agriculture, Farmers in a Changing World,* or the 1943–1947 *Yearbook, Science and Farming.* Both yearbooks are issued by the U.S. Department of Agriculture.
2) Write an essay on "Why I prefer (or do not prefer) farming as a way of life."

# *LESSON* 54 THE FARM PROBLEM

## The Story of a Farmer

The following biography of a farmer in Minnesota, taken from a newspaper article of the early 1930's, reveals the nature of the farm problem:[1]

By 1912, Ole, then thirty-five years old and a renter, had accumulated some $2000 in cash, two teams of horses, a reasonable supply of implements, a few breed cows and some cattle. He decided to buy his deceased father's farm of 160 acres in southern Minnesota for $20,000. He paid $2000 in cash, gave an $8000 second mortgage to the estate, and a $10,000 first mortgage to an insurance company.

Between 1912 and 1920, because of exceptional thrift and competence, Ole was able to pay off the entire second mortgage of $8000, besides improving his barns, adding more cattle to his herd, increasing his equipment, and building a porch to his home, and making other improvements, as well as

[1] Bernhard Ostrolenk, "The Farmer's Plight: A Far Reaching Crisis," *New York Times,* September 25, 1932, Section VIII, p. 1.

buying furniture, rugs and books, and giving his children an adequate education.

But between 1920 and 1928 Ole found his expenses, because of the industrial prosperity, were increasing. He had to pay more and more for labor and for goods. On the other hand, because of the drop in agricultural prices, his income was constantly falling. So, in those years, he was unable to amortize his remaining $10,000 mortgage, and moreover, found that his standard of living was rapidly dropping. By 1925 his net income for his labor had fallen to less than $400 annually. His eighteen-year-old daughter, who had become employed in town as a typist, with no experience whatever and without invested capital, was earning $15 a week, or nearly $800 a year, almost twice what Ole was earning for his labor during that period.

In 1929 Ole was unable to pay interest of $600 and taxes of $300, and was compelled to give the insurance company a chattel mortgage for the interest debt. In 1930 he was compelled to give an even larger chattel mortgage.

In 1931 his gross income was insufficient to meet either taxes or interest, and his insurance company, now having failed to get interest for three years, foreclosed the mortgage in the spring of 1932. Ole, at the age of fifty-five, was again a renter on his father's farm—the farm upon which he had been born and on which he had labored for a quarter of a century; having lost his entire equity of $10,000, he was left carrying a burdensome chattel mortgage.

This brief biography of Ole Swenson reveals the fundamental character of the farm problem, as it has developed in this country over the past hundred years and more. There have been periods, such as those of the War Between the States and its postwar years, from 1896 to 1920, and the 1940's, when the incomes of American farmers were high. Although expenses were also high, the farmers were able to make a profit and to raise their standards of living. There have been other periods, such as the 1870's, and 1880's, and the 1930's, when farm incomes have dropped faster than expenses, thus lowering farmers' standards of living, in some cases to the poverty level. It is during these periods that the farm problem has come to the fore.

In order to understand the reasons for these long periods of "farm crisis," we must examine the factors underlying the farmers' income and expenses.

### Factors Influencing the Supply of Farm Products

Since the early nineteenth century, farming in this country has benefited from the *agricultural revolution*—the increasing application of machinery and scientific methods to farm production. Just as the industrial revolution brought huge increases in the production of manufactured goods, so the agricultural revolution led to a vast increase in farm production. The expansion of farm production was encouraged by the fact

that improved means of transportation created a world market for farm products.

This expansion of farm output has been a great benefit to consumers, and has made possible the concentration of population in large cities. But for the farmer it has meant an unstable income, because of a continual downward pressure on his selling prices—except for occasional periods of inflation.

There has been a similar expansion of production of manufactured goods, and also a long-run downward movement of prices of these goods. Yet the major manufacturing industries have not faced the same kind of crises as the farmers have faced. There are several reasons for this difference.

The farmer does not have the same control over his production as does the manufacturer. His crops are affected by natural factors which he can control only to a limited extent—weather, insects, and plant and animal diseases, for example. Moreover, growing and breeding times cannot be adjusted to fit changing business conditions. The manufacturer can more easily and quickly adapt his volume and quality of production to changing conditions.

The farmers generally have less control over the prices of their products than the manufacturers. As has already been explained, many manufactured products are sold under brand names and under conditions of monopolistic competition. A major part of farm products is sold, on the basis of standardized grades of quality, to packing plants, mills, canneries, and factories. The buyers are mainly large business enterprises, which are in a stronger bargaining position than the farmers. The sellers, the farmers, number in the tens, even hundreds, of thousands. Wheat is produced on over a million-and-a-quarter farms; cotton is grown on almost a million; corn is raised on four-and-a-half million; tobacco is a cash crop on nearly half-a-million; cattle are a product on about five-and-a-half million; chickens provide income on close to six million farms. Although some farms are large, concentration of production is very low.

In the cases of cotton, wheat, and hogs, about one-tenth of 1 percent of each was produced by the four leading producers. Contrast this with the fact that, in manufacturing, the four leading producers, in three-fourths of the products studied, produced over 50 percent of the output. Market leadership, restriction of output, and stability in prices have been less possible for the products the farmers sell than for the goods and services the farmers buy.

Not only do the farmers find it difficult to control their selling prices, but as the prices of farm products decline, they find themselves forced to keep up production, thereby hastening the fall of farm prices. In

this respect they are in the same position as small businessmen in a highly competitive industry. A large part of the typical farmer's expenses are fixed. He must pay annual taxes on his land, and the amount of real-estate taxes is not directly related to his income. Besides taxes, the farmer must spend a given amount each year for equipment, fertilizers, repairs, and labor; and he cannot tell just how large his crop will be at the end of the season. Often he borrows from the local bank in the spring, to cover these expenditures, with the intention of repaying the loan after the crop has been sold. This short-term debt is a fixed expense. In addition, he may have borrowed on a long-term mortgage, in order to buy land or machinery, or to put up new buildings; and therefore has annual payments of interest and principal. As long as income remains reasonably up to expectations the farmer can meet these obligations. If prices drop, the farmer has to produce and sell more in order to get the income to cover the fixed costs. If many farmers do this at the same time, the effect is to increase supply and to push the price still further down.

This pressure of low farm prices on production has already been pointed out in connection with the study of flexible and inflexible prices. As shown in the chart on page 280, despite the sharp declines in the prices of farm products, production of farm products continued at a high level.

### Factors Influencing the Demand for Farm Products

The *farm surplus* means that a greater supply is being produced and marketed than can be sold at prices which will yield the farmer a satisfactory income. A number of factors have contributed to the development of farm surpluses.

As standards of living have risen, the tendency has been to introduce more variety into diet. While there has been a rise in per-capita consumption of citrus fruits, dairy products, and vegetables, there has been a decline in the per-capita consumption of such staples as wheat, pork, and potatoes. In addition, the substitution of tractors for farm animals has reduced the demand for feed crops, such as oats; and has released these fields to increase the production and supply of other grains.

Although population has grown, the rate of increase of population has lagged behind the rate of increase in farm output. Restriction of immigration has also limited the home market for agricultural products.

Technological advances have produced artificial and synthetic substitutes for natural products; rayon and nylon, for example, compete with cotton and wool.

Another important factor has been the shrinkage of foreign markets. American exports of farm products have been replaced to a large extent

by Argentinian beef, Indian and Egyptian cotton, and New Zealand and Canadian dairy products, for example. Our high tariff policy encouraged other countries to place tariffs on imports from the United States; our unwillingness to buy from other countries reduced the funds they had for buying from us. The ambition of nations to become self-sufficient, because of the threat of war, leads them to encourage their own production at home and in colonies, and to curtail their reliance on imports. In the five-year period from 1911 to 1915, exports contributed an average of 15 percent per year to American farm income; for the three years from 1935 through 1937, the annual average dropped to about 8 percent. The American farmer has been one victim of the struggle among nations for economic self-sufficiency.

### The Paradox of Value

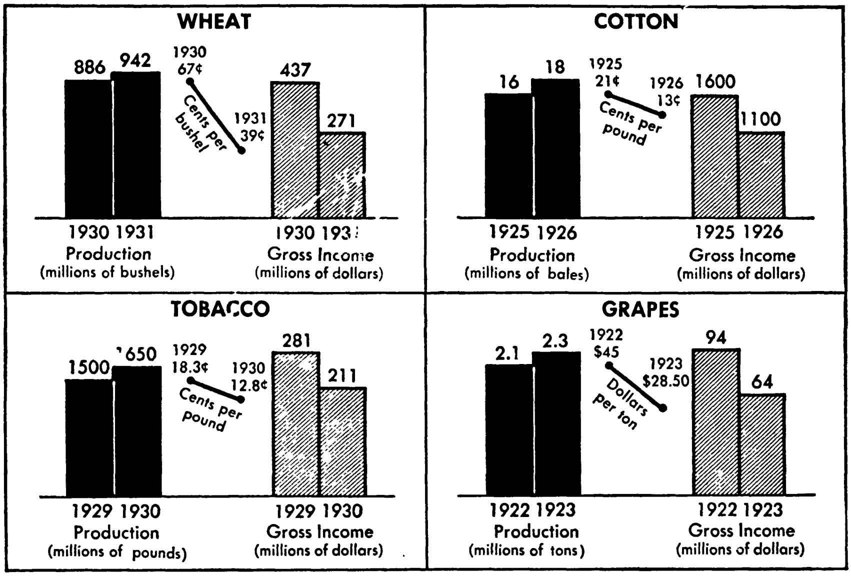
Because of the factors influencing demand for farm products, farmers find surplus production a problem. If the supply of wheat or potatoes or apples is greater than the amount normally consumed, the farmers must cut the price sharply in order to sell the surplus. A relatively small increase in supply may bring such a large decline of price that farmers may receive less income from a larger crop than from a smaller crop. This situation is referred to as the *paradox of value.* It means that, in some cases, when the supply of an article increases beyond a certain point, the price of the article drops so rapidly that the total value of the larger supply becomes lower than the total value of the smaller supply. It is clearly to the interest of the sellers to keep supply below that point. The paradox of value is illustrated in the chart on page 421.

The paradox of value explains why farmers resort to drastic methods of keeping down the market supply. Truck farmers have dumped surplus vegetables and fruits into the river to prevent excessive drops of prices. Dairy farmers have spilled milk into the fields in order to keep up the price of milk. Sometimes governments have helped farmers to avoid the effects of the paradox of value. Our own government has paid farmers subsidies (bonuses) to limit production of crops. The government of Brazil, when there was a surplus of coffee, dumped shiploads of coffee into the ocean and used coffee as fuel in locomotives. The government of Japan bought surplus silk and stored it in warehouses so that the price of silk would remain at a profitable level.

### The Farmers' Complaints

Competition, oversupply, and falling prices are not peculiar to farming. They are common occurrences in other fields of enterprise, too. Yet the farmers feel that their situation has been worse than that of other

producers. For one thing, farm prices drop sooner and more sharply than the prices of manufactured goods. As a result, there have been times, such as the 1920's, when farm incomes were shrinking at the same time that business conditions in general were good. Another result has been that the farmers' costs have not dropped in proportion to the drop in their incomes.




*The Paradox of Value.* When supply is too great, the lowered prices may result in a lower income than was produced by a smaller supply. Above are four cases. In 1930, for example, with a crop of 886 million bushels, wheat farmers received an income of 437 million dollars; in 1931, with a crop of 942 million bushels, their income was only 271 million dollars. (Data from Bureau of Agricultural Economics, Technical Bulletin No. 703)

Farmers have felt that the price of the goods and services they have had to buy has been excessive. One reason has been high cost of farm credit. Until the federal government began a widespread system of farm-credit assistance, the interest paid by farmers was high. There has been a tendency for interest on loans to farmers to be higher than on loans made to businessmen in cities. The main reason has been the greater risk to the lender of loans to farmers. Other factors have been the relative lack of banking resources in rural communities and the concentration of farmers' credit needs in one season of the year.

A second reason has been monopolistic conditions in industries selling to farmers. The farmers were the chief victims of the rate discrimination

practiced by the railroads in the nineteenth century. Farm machinery, steel fencing, building materials, household appliances, automobiles, and the many other things entering into the farmer's business and family buying have tended to be less competitive than his own product. The high cost of manufactured goods has, in the opinion of the farmers, been further maintained by the policy of protective tariffs. Hence, during periods of price decline, the prices of manufactured goods have not dropped as much as the prices of farm products.

Another complaint of the farmer has arisen from the difference he notes between the price for which he sells his products, such as milk and vegetables, and the price charged for it to the final consumer in the retail store. He resents the fact that very often the middlemen have made money, while he has suffered losses. "There are three great crops raised in Nebraska," once wrote an agricultural editor. "One is a crop of corn, one a crop of freight rates, and one a crop of interest. One is produced by farmers who by sweat and toil farm the land. The other two are produced by men who sit in their offices and behind their bank counters and farm the farmers."[2] Whatever the facts behind the controversy over costs of distribution, the farmer has argued that he is getting too small a share of the price paid by the consumer.

### Whose Problem Is the Farm Problem?

If the sad story with which this lesson started were confined to Ole Swenson, we could afford to sympathize with him and forget about it. When the same situation affects thousands and thousands of farmers, it becomes a national calamity. Although agriculture produces only 10 percent of the national income, the welfare of the entire nation is involved in the economic status of the farmer.

Farm mortgages are held by banks and insurance companies. In the story of Ole Swenson, the interest was not paid for three years; finally the insurance company had to foreclose the mortgage and go into the farm real-estate business. Danger to the investments and income of banking and insurance institutions is danger to the income and security of stockholders, depositors, and policyholders. By far the largest proportion of bank failures in the 1920's and 1930's took place among small country banks specializing in farm credit.

Farmers are an important market for all kinds of goods, such as machinery, equipment, paint, lumber, appliances, furniture, clothing, and processed food. A shrinkage in farm income causes less buying by farmers, a reduction in business for manufacturers, a rise in unit costs,

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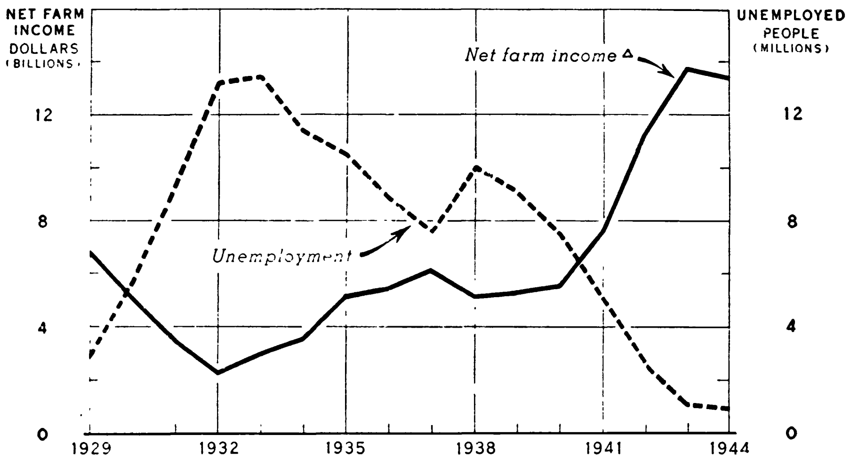
[2] Quoted from a farm journal by Arthur M. Schlesinger, *Political and Social Growth in the United States—1852–1933*, The Macmillan Company, 1935, p. 257.

and the possibility of reduced industrial activity. The result may be wage cuts and unemployment in industry. The reduction in incomes of city workers may have the effect of further contracting demand for farm products, so that a downward spiral of all business activity begins. This interaction between unemployment and farm income is shown in the graph which follows.

NET FARM INCOME AND UNEMPLOYMENT, 1929-44*




* BAE ESTIMATES Δ NET INCOME OF PERSONS ON FARMS, FROM FARMING, INCLUDING GOVERNMENT PAYMENTS

**Except for the year 1932–33, periods of rising unemployment have coincided with periods of falling farm income. Does low farm income cause unemployment, or is the reverse true? Can some other factor affect both? (U.S. Dept. of Agriculture)**

Low farm income means inability to pay taxes. Local governments then find their tax revenues declining, at the same time that their expenses for relief and assistance to farm families rise.

Finally, low income makes it impossible for a farmer to follow sound conservation practices. He will seek to produce the one crop that yields the most cash; and avoid the expenses involved in conserving the soil. The farm problem is everybody's problem.

## Exercises and Activities

I Dictionary of Economic Terms

agricultural revolution    farm surplus    paradox of value

II Questions and Problems

1) Look up and explain the meaning of each of the following terms as used in the biography of Ole Swenson on page 416; (a) renter,

(b) second mortgage, (c) first mortgage, (d) amortize, (e) chattel mortgage, (f) foreclosed the mortgage, (g) equity.

2) "The essence of the farm problem may be summed up in the word 'surplus.'" (a) Explain this statement. (b) Why have farmers found it more difficult to meet this problem than manufacturers?

3) Why does the fact that farming has a high proportion of overhead cost tend to encourage the expansion of production even though prices are falling?

4) "The farmer buys in relatively monopolistic markets and sells in relatively competitive ones." (a) Explain this statement. (b) How does this help to explain the difficulties faced by the farmer?

5) What factors have caused the spread between farm prices and retail prices to be so large? (Consult Lesson 32)

6) (a) Explain what is meant by the "agricultural revolution." (b) Show by examples how it caused farm production to rise.

7) Using the data given in this lesson and Lessons 36–37, prove that farming tends to be more competitive than manufacturing industry.

8) List and explain four factors explaining why demand for farm products may not keep pace with increasing farm supply.

9) Show how the interests of the farmer are related to the interests of (a) city workers, (b) manufacturers and other businessmen, (c) investors, (d) banks and other financial institutions.

10) The graph on page 423 shows a correlation between farm prices and unemployment. Criticize the statement that "this offers conclusive proof that a drop in farm prices means an increase in unemployment."

11) Why did World War I first bring prosperity and then intensified difficulty to farmers?

### III Things To Do

1) Read *Farming in America* by Harold S. Sloan (Harper, 1947), a very readable brief treatment of all phases of the farm problem.

2) Report to the class on accounts in your history textbook of problems of the farmer, or find and report on a newspaper article discussing a farm problem.

# LESSON 55 MAINTAINING FARM PRICES AND INCOME

### Government Buying and Price Support

In 1933, headlines like the following appeared frequently in the newspapers:

"1000 FARMERS ACT TO BAR FORECLOSURES"

"FARM CRISIS RISES, LAW BREAKS DOWN"

"FARM PICKETS FIRE IOWA RAIL BRIDGE, SHOOT INTO TRAIN"

The farm problem of the 1920's had become the farm crisis of the 1930's. Since the early 1920's farm prices had fallen more than farmers' costs, with the result that the farmers' real income had shrunk. Many farmers had lost their farms because of their inability to pay their debts, and many more faced similar prospects. Finally, the farmers had resorted to defiance of the laws, even violence, in order to prevent foreclosures of mortgages, to block shipment of crops, and to get action from the government to stop the fall of prices on farm products.

The measures used in meeting the problems of the farmer have been many and complex. In previous lessons there have been mentioned measures for monetary reform, for easing farm credit costs, for improving farm methods, and for reducing rural poverty.

The most important aspect of the farm program, however, has been that which aims at raising and maintaining, at a reasonable level, the prices and incomes which farmers receive. Some procedures have been direct in that they have involved the fixing of minimum prices, as in the case of the prices paid to dairy farmers by dairy companies. Some have been more indirect, in that they have attacked the problem of surplus by schemes to reduce market supply, and to increase market demand.

One such plan was used in the Agricultural Marketing Act of 1929. It provided for the federal government to enter the open market as a buyer of farm products. The aim was to have the government store this surplus production, and hold it off the market, so that prices would go up. Then it could be sold without disturbing the price received by farmers for their current crop. But this legislation failed in its objective, because it did not provide for reduction of surplus crops. Huge government hoards remained in storage, a potential threat to prices should the government decide to sell.

Used as a lone device, government buying and storage was a failure. In 1933, legislation was passed to encourage crop restriction by farmers (Agricultural Adjustment Act of 1933). As we shall see, crop restriction by itself was not completely effective, so that in 1938, a modified system of government acquisition and storage of surplus production was again introduced (Agricultural Adjustment Act of 1938). By combining crop restriction with government storage of surplus production, the program aimed at avoidance of too much production in one year and too little in another. (This aspect of the current farm program is often referred to as the *ever-normal-granary plan.*) It is a program for *price support,* a policy whereby the government fixes a minimum price for a product and then takes steps necessary to make the price effective.

An important method by which the government's price-support program operates is the *crop (or commodity) loan.* This is a special type of loan, for which the farmer pledges his crop as security. The amount lent depends on the size of the crop and on the support price which is

the basis for the loan. For example, if the crop is 1000 bushels of wheat and the support price is set at $2.00 per bushel, the government lends the farmer $2000. If the market price should fall below $2.00, the farmer need not repay; he may deliver his crop to the government warehouse instead. The effect would be to increase government stores of wheat. Since farmers will be unwilling to sell for less than the support price on which the loan was based, there will be a tendency for that price to become the minimum market price. If, on the other hand, the market price should be higher than $2.00, the farmer may sell his crop in the open market, repay the loan, and pocket the difference. Thus the farmer is assured of not less than the support price which was the basis of the loan; yet he may get more if market prices go above that level.

The government agency created to finance the program of acquiring and storing crops under the price-support program is the Commodity Credit Corporation (CCC). It was provided with initial capital by the government, and in addition was empowered to borrow several billion dollars "on the credit of the United States."

During the latter part of the 1940's, the commodity-loan program was criticized as keeping up the cost of food for city people. As a result, there was much discussion of a plan (offered by Secretary of Agriculture Brannan) to make prices to consumers lower, while maintaining farm incomes. It proposed that farm products be permitted to sell at whatever the market would bring, rather than be kept at a support price. The government would pay the farmer a subsidy, which would be the difference between market price and the set price. It was argued that lower market prices would increase demand and decrease surplus. This, it was claimed, would make the cost of government subsidies to the farmer lower than the cost of the price-support program, and would at the same time benefit the consumer. The opponents of the subsidy plan claimed, however, that it would be more expensive than the crop-loan program and would lead to socialistic control of agriculture.

### Restricting Farm Production

Government buying and price support, by themselves, do not reduce production. In fact, if price is raised, the result may be to stimulate farmers to expand output. Hence in 1933, the Agricultural Adjustment Act established a new government agency, the Agricultural Adjustment Administration (AAA), to supervise a program of restriction of crop production. This remained a basic part of the government's farm program in succeeding legislation.

The method has been referred to as a system of *domestic allotment,* that is, a scheme of alloting the number of acres each farm is permitted

to devote to the cultivation of the particular crop under control. First, in accordance with studies of supply, demand, and price, the total number of acres to be sown with the particular crop, in the entire nation, is determined. This total is then divided up, or allotted, among the states, then among the counties of each state, and finally among the individual farms.

The farmer's participation in this program is, however, voluntary. It is encouraged by the payment of a specified sum depending upon his acreage reduction; this is called a *benefit payment.* If the program is successful in keeping production down so that market supply is reduced, the farmer may hope to reap the reward of higher prices and higher income. To qualify for benefit payments, the farmer must plant soil-conserving crops on the acres he keeps out of production. The crop-restriction program is thus used to further soil-conserving practices; this is shown in the title of the act passed to replace the law of 1933—the Soil Conservation and Domestic Allotment Act of 1936.

Limiting the number of acres planted does not guarantee that surplus production will be eliminated. By using improved or more intensive methods of cultivation, the farmer may increase the production per acre. The size of the crop is also affected by weather, insects, and other natural factors not related to the number of acres used. Furthermore, demand may shrink faster than production and supply. Competition from foreign producers may become more intense. Hence there is need for the additional measures of government buying and price support previously described. In addition, there is need for limitation of the amount marketed by farmers as well as limitation of amount produced. When a stated proportion of the farmers producing a particular crop agree, the government may permit and enforce a system of *marketing quotas.* This means that each farmer is allowed to sell only a certain amount, a percentage of his average marketing in previous years, and must keep the balance off the market. The surplus product can be put on the market only upon payment of a special tax.

### Parity—the Measuring Rod

How far should the program of crop restriction be carried? What should determine the point at which support prices are fixed? The idea of *parity price* has been devised to answer these questions.

The purpose of the farm program has been to give the farmer a real income equal to, on a par with, the farmer's real income during a selected period, or base period, in which his income was considered to be normal. As you have already learned, real income is determined by the relationship between money income and the cost of goods bought with the money income. To give the farmer the desired real income, it is

necessary that the price of his product be kept from dropping below a set ratio to the prices of the goods and services he buys. Many farm products have, therefore, been given a parity price.

Parity price is that price, for a farm product, which will give the farmer the same purchasing power as he had in the base period. For most crops subject to control, the base period has been the five-year period before World War I, 1909–1914. (Recently the parity formula was changed to give consideration also to farm prices and incomes in the 1940's.) Thus, a farmer receiving parity price for his crop in 1950 should have been able to buy as much with what he received as the farmer in 1909–1914 could buy with the price received then. An example of the calculation of parity price is shown below:

GIVEN: Price of wheat during the base period (1909–1914)—88.4¢ per bushel
Index number of prices paid by farmers September 15, 1948 for nearly 200 items of production and living expense (1909–1914 = 100)—250

TO FIND: Parity Price for wheat on September 15, 1948

CALCULATION

1. It cost farmers $2\frac{1}{2}$ times as much to buy what they needed on September 15, 1948 as it did in the base period:

$$\frac{\text{Index number, Sept. 15, 1948}}{\text{Index number in base period}} = \frac{250}{100} = 2.5 \text{ or } 2\tfrac{1}{2}$$

2. Therefore to buy as much on Sept. 15, 1948, as in the base period, the price received would have to be $2\frac{1}{2}$ times as great as the price in the base period:

$$88.4¢ \times 2\tfrac{1}{2} = \$2.21 \text{ per bushel}$$

3. Parity price for wheat on September 15, 1948—$2.21 per bushel

The parity price has been used as a basis for the support, or commodity-loan, price. Thus, on September 15, 1948 the commodity-loan price for wheat was set at 90 percent of parity; the commodity-loan price for wheat was 90 percent of $2.21, or $2.00 per bushel.

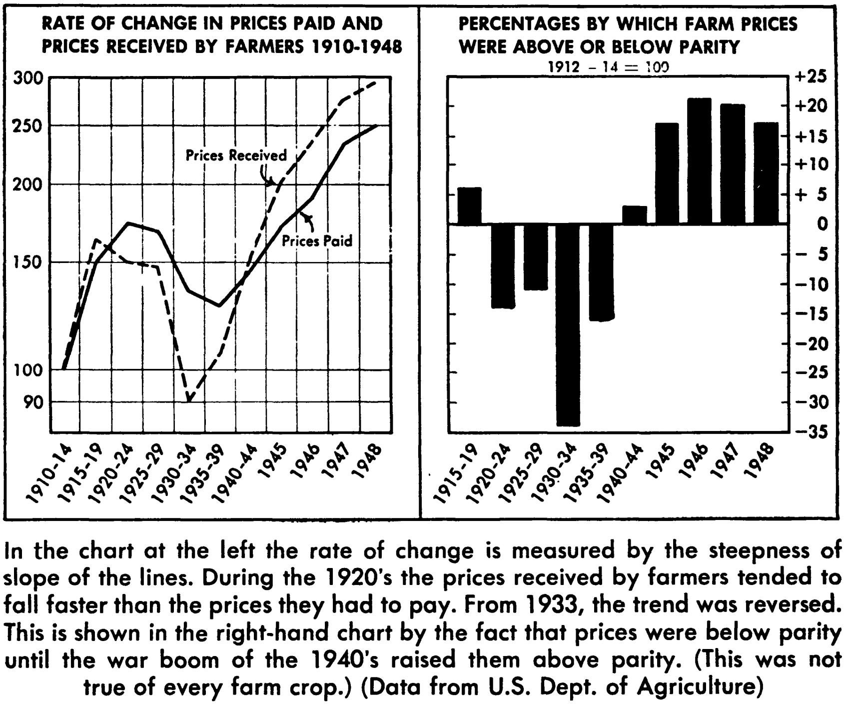
As the charts opposite show, it is unusual for prices to be exactly at parity. During the depression years, prices continued below parity despite efforts to reach it. During the war years, prices rose above parity, even above the 110 percent of parity which was the limit set by wartime price-control legislation. Parity itself fluctuates; a rise in the cost of goods purchased by farmers raises parity prices, and a decline in such costs lowers parity prices. Parity is the moving goal of the farm-price program.

### Increasing Demand for Farm Products

Measures to increase demand are also a way of reducing farm surplus. Farm coöperatives, agricultural schools, government agencies, and private industry have carried on research to find new uses for farm prod-

ucts. Soybeans have become a basic raw material of the plastics industry; waste products of the farm are used to make building board; vegetable oils, fertilizers, animal feeds are some of the products now produced from seeds and other agricultural waste that were formerly thrown away.

Efforts have been made to increase farm exports. Export subsidies have been used to help farmers sell surplus cotton and wheat to foreign markets. The farmers sold their crops at whatever price they could get, and the government made up the loss by a subsidy.




**In the chart at the left the rate of change is measured by the steepness of slope of the lines. During the 1920's the prices received by farmers tended to fall faster than the prices they had to pay. From 1933, the trend was reversed. This is shown in the right-hand chart by the fact that prices were below parity until the war boom of the 1940's raised them above parity. (This was not true of every farm crop.) (Data from U.S. Dept. of Agriculture)**

International conferences have been held in an effort to unfreeze the channels of international trade, in order to enlarge the exports of farm commodities. The Marshall Plan for stimulating the paralyzed economies of the world, in the years following World War II, stimulated demand for American farm products.

In discussing measures for reducing farm supply, the program of government buying and storage was mentioned. Schemes for disposing of government stocks had to avoid bringing the supplies into competition with new crops being offered for sale. A device used during the depression was the "food-stamp plan." Families on relief were given colored stamps with which government surplus stocks could be bought.

Surplus foods have been used to give free or below-cost lunches to school children.

During the depression years, the most important means by which demand for farm products was raised was the program of relief and of keeping up wages and purchasing power. Fundamentally the demand for farm products depends upon the purchasing power available to buy food and agricultural raw materials. This is as true in times of prosperity as it is in depression. Maintaining employment and stability of income in the entire economy is the surest measure to maintain demand for farm products.

### Encouraging Coöperation Among Farmers

Recognizing that farmers face too much competition, and that the danger of monopoly is remote, the government has encouraged farmers to organize to achieve better markets. The Clayton Antitrust Act of 1914 and the Capper-Volstead Act of 1922 stated that farm coöperatives are not to be considered combinations in restraint of trade. Farm-credit legislation has made wide use of the coöperative device.

A *farm marketing coöperative* is an association of farmers formed for the purpose of joint marketing of a product. Each farmer-member delivers his crop to the coöperative, which markets the combined crop of the members at the best time, place, and price. Each member receives a share of the net proceeds in proportion to his deliveries to the coöperative. The effect is a larger total sold by a single seller (the coöperative), and this makes for more effective control of supply and price. In some cases coöperatives have been able to brand farm products and to engage in advertising campaigns. A notable example of a marketing coöperative has been the California Fruit Growers' Exchange, which, in 1941, shipped about 70 percent of the citrus fruit originating in California and Arizona. The effectiveness of coöperatives in market control has been greater in specialized and localized crops than in staple crops grown on a national basis.

Coöperatives have undertaken other functions. They have engaged in research to find new uses and increase demand. They have sought to find better methods of production and transportation. They have acted as buying agencies for their members, making it possible, in some cases, to use expensive equipment coöperatively. They have acted as coöperative buyers of consumers' goods and as employment agencies for securing seasonal labor, and have exerted influence upon members of state and federal legislatures.

### The Controversy over the Farm Program

There has been considerable controversy over the program for maintaining farm prices. The farmers, though agreed on the desirability of

raising prices, have disagreed as to methods to be used. Objections to the farm legislation have been made on the grounds that it costs too much and is a burden on the taxpayer for the benefit of the farmer. Critics have objected to the program to restrict production and to limit market offerings as being a program of "planned scarcity." They argue that standards of living depend upon the fullest possible production consistent with conservation of resources, and that the farm program encourages reduced production and supply. They assert, too, that the success of the farm program is measured in terms of higher prices to consumers, which means higher costs of living and lower standards of living for the rest of the population. As technology improves and ability to produce increases, maintenance of the farm program will require greater and greater expenditure by the government, and government subsidy of the farmer will become a permanent institution. Finally, say some critics, raising prices at home merely stimulates foreign competitors to increase their production and to create world-wide surpluses. This makes it more and more difficult to realize the aim of the program.

Those who defend the program point to the need for equalizing the position of farmers and other businessmen. Individual farmers have been unable to avoid conditions of cutthroat competition. Poverty forced upon 25 percent of the population will spread and infect the entire community. The cost of stable and reasonable farm prices to taxpayer and consumer is small compared with the loss of income businessmen and workers suffer when farmers are badly off. Furthermore, argue the advocates of government action, the soil-conserving features of the farm program alone should be sufficient to justify the cost. Finally, the argument runs, the crop- and price-control system is a compromise between two undesirable extremes: on the one hand, complete fixing of farm prices and incomes, and, on the other hand, a policy of laissez-faire, with the disastrous results of the 1920–1933 period. Certainly, it is claimed, if the interests of the entire nation require organization by labor to improve its condition, and authority given to industry to introduce restrictive practices that will maintain a profit, there can be no question about the need for a program to assist the farmer.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| benefit payment | ever-normal-granary plan | parity price |
| crop or commodity loan | marketing coöperative | price support |
| domestic allotment | marketing quota | |

## II Questions and Problems

1) (a) Explain how government buying of farm products may be a means of improving conditions for farmers. (b) How might the experiences under the Agricultural Marketing Act of 1929 be an argument against this type of solution? (c) State two arguments in favor of government buying of surplus crops.
2) Explain the procedures by which a crop loan becomes a means of supporting farm prices.
3) Explain how each of the following contributes or contributed to solving the farm problem: (a) the Agricultural Marketing Act of 1929, (b) the Commodity Credit Corporation, (c) the Agricultural Adjustment Act of 1933, (d) the Soil Conservation and Domestic Allotment Act of 1936, (e) reciprocal trade agreements, (f) industrial and agricultural research.
4) In parallel columns list arguments for and against the government's program of farm-price support.
5) (a) Explain the difference between the Brannan Plan and the system of price support in effect in 1950. (b) What advantages or disadvantages do you see?
6) (a) Explain the purposes of having a "parity price" for each commodity. (b) Why is an index of prices paid by farmers necessary to compute parity price?
7) List and explain two methods for increasing the demand for farm products.
8) Explain the purposes and organization of a farm marketing coöperative.
9) Farm coöperatives have been declared exempt from the provisions of the antitrust acts. Why? Do you regard this exemption as desirable? Explain.
10) During the war farmers were permitted to have prices as high as 110 percent of parity under the terms of price-control legislation. (a) How could farm organizations justify getting higher-than-parity prices? (b) What objections could be made?

## III Things To Do

1) Read *The American Farmer* by Lee Fryer (Harper, 1947), a short book which deals with the farm problem of the future.
2) Use your history textbook and report on one of the following: (a) the farmer and "cheap money" proposals (see also Lesson 48), (b) the work of the Farm Credit Administration, (c) the Capper-Volstead Act (dealing with coöperatives).
3) Arrange a debate or forum discussion on one of the following topics: (a) Should farm price supports be made a permanent feature of our system? (b) Should the Brannan Plan be adopted? (c) Is crop restriction socially desirable?

# *UNIT 10*

## PROBLEMS OF THE WORKER


*56* LABOR AND LABOR PROBLEMS

*57* THE BASIS OF WAGES

*58* HOURS AND WORKING CONDITIONS

*59* THE PROBLEM OF SUBSTANDARD WORKERS

*60* PROBLEMS OF INSECURITY

*61* SOCIAL SECURITY

# LESSON 56 LABOR AND LABOR PROBLEMS

## THE MEANING OF LABOR

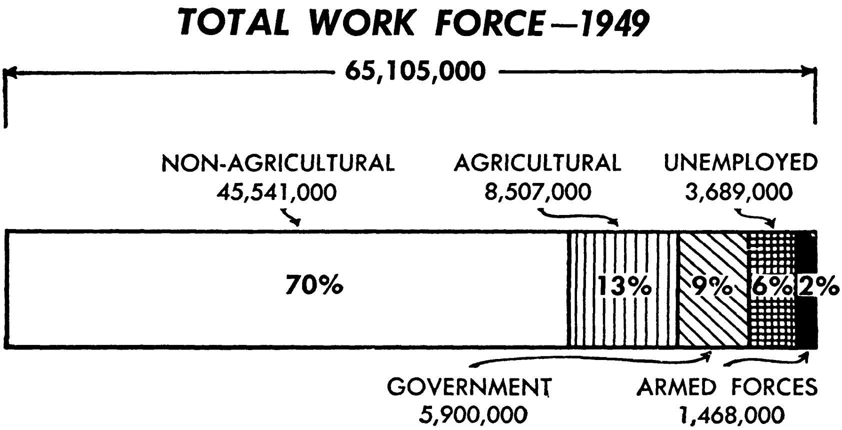
The term *labor force* may be used to denote all individuals who work in order to gain an income. The largest part of this labor force in the United States is made up of *wage earners;* that is, individuals who work for others, and receive payment in return. They include the skilled, semiskilled, or unskilled worker in factory, mine, or office; the farmer's hired hand; the domestic servant; and the salaried professional man. A smaller, but nevertheless substantial, part of the labor force is made up of individuals who operate business enterprises. Although in some cases they receive salaries from the business, their incomes depend mainly upon the profits earned by the business. This group is often called the *self-employed.* It includes businessmen, farmers, independent craftsmen, and professional men, all of whom sell goods or services. The housewife, despite the fact that she works hard and renders essential services, would not be included as part of labor; nor the student spending his efforts on school work.

In 1949, the total labor force was estimated to be about 65 million persons, approximately 40 percent of the total population. The self-employed accounted for about one-fifth of the labor force—professional persons about four million, businessmen about four million, and farmers about six million. The remainder, consisting of wage earners, totaled over 50 million, more than three-fourths of the labor force. The make-up of the labor force in 1949, classified according to major types, is shown on a percentage basis in the chart on page 436.

It is the wage earners who are most commonly referred to when the term "labor" is used. Those who are in business for themselves are generally not included as labor, although they may work hard and perform tasks requiring great skill. Owners of business enterprises often receive salaries for their services, but their income depends largely upon the profits of the business. A more difficult problem related to the classification of workers arises out of the fact that some employees of business enterprises are hired in order to supervise and manage the business. In large corporations, for example, the officers and chief executives often hold only a small part of the shares of ownership, sometimes none at all. Despite the fact that they are not really owners, they are expected to hire and fire, adjust wages and working conditions, and in general act

as if they were owners. Although they are salaried employees, corporate officers are generally considered to be part of *management*—the group which organizes and supervises the factors of production.

A somewhat more controversial problem is how to classify foremen and other minor supervisors. In some industries, foremen have joined trade unions; but employers have protested against classifying their foremen as ordinary workers.




The work force, or labor force, includes all who work or can work productively, whether self-employed or working for another. The percentage employed is often a key to the prosperity of the nation. (Data from U.S. Dept. of Commerce)

WHAT ARE LABOR PROBLEMS?

If one were to ask a factory worker, a miner, a farm hand, or other wage earner, "What are the problems of labor in your industry?" the answer might include the following:

How can a fair level of wages, sufficient to provide for the needs of my family, be provided for the work which I do?

How can I avoid the constant fear of losing my job and income?

How can I secure safe and healthful working conditions?

How can I get a fair hearing for my claims for satisfactory wages, job security, and good working conditions?

The worker tends to view the problems of labor as the amount of income received for his labor, and the conditions under which he works.

If a manufacturer, mine owner, farmer, or other employer were to be asked, "What are the problems of labor in your industry?" the answer might include the following:

How can I obtain a labor force, possessed of the necessary skill, at a cost which business conditions in my industry make it possible to pay?

How can I provide the wages, working conditions, and job security demanded by workers without increasing prices and losing customers?

How can I avoid dictation by organizations of workers about business policies?

The employer tends to view labor as a factor in production, and to think in terms of a comparison between the cost of labor and the selling price of the commodity which he sells.

Out of this difference in point of view arises the familiar phenomenon of conflict between labor and management. To the worker, the job, while it may also be a source of pride and interest, is fundamentally a source of income. To the employer, although he may have humanitarian ideals of the highest order, the worker is a means of production, the cost of which must be paid for from the proceeds of his sales. This difference in point of view takes the form of actual dispute when the workers feel that their standard of living is not rising sufficiently fast, or is actually dropping. Thus, a period of rising prices will provoke demands for rising wages and better working conditions. When business is bad, workers are laid off and their wages and working conditions are depressed. Changing economic conditions increase labor-management conflict.

From the point of view of labor and management, then, the labor problem consists of a number of related questions. First is the problem of wages, which affects the workers' standards of living and the employers' profits. Second is the problem of working conditions. This includes provisions for health, safety, hours, speed and difficulty of work, vacations, and all matters pertaining to the job other than wages. To the worker these are of importance to his health and way of life. To the employer these are factors which affect the efficiency of labor and influence his labor costs. Third is the problem of *security.* To the worker this means the absence of fear of losing income through layoffs, wage cuts, illness, advancing age, and advancing prices. To the employer this is a problem of keeping his business stable—of avoiding the expenses which come from too much hiring and firing, training and retraining; and of retaining his power to decide who is to be hired or fired and when. Fourth is the problem of labor-management relations. To the worker this means the right to organize and join unions, through which he can present demands to the employer, and bargain for improved conditions. To the employer this is the problem of managing his business and fixing its policies without undue interference from organizations of workers.

### Labor Problems and the Public Interest

The approximately forty million workers who work for others, together with their families, make up about three-fourths of the popula-

tion. Yet it would be wrong to consider the terms "labor" and "public" as meaning the same thing.

In the first place, labor is not a single group of forty million persons, working alike, thinking alike, and acting together. Labor consists of many thousands of groups, large and small, with a variety of interests and ideas. About fifteen or sixteen million workers are members of unions; the rest are not. Some are highly skilled craftsmen, secure in the knowledge that they are hard to replace. More are semiskilled and unskilled and are more easily replaceable. Some do clerical work, some do manual work, some work on farms, others work in mines and factories. Some work for small firms, know the employer personally, and have a feeling of friendly loyalty; others work for large concerns, where they are small cogs in vast machine-like enterprises. Those who belong to unions are not a single organized mass of labor. They belong to different unions. Sometimes these unions are divided by political issues unrelated directly to the wages and conditions of work on the job.

In the second place, every worker is at the same time a consumer of goods and services. In a general sense all workers have a common cause —fair wages, good working conditions, job and income security, and the right to organize to protect their interests as workers. But they are also consumers of each other's products and would like to get more goods and services at lower prices. The factory worker in the city may resent a strike among coal miners, if the effect is to keep his house cold during the winter. The unskilled factory hand may look with envy on the high wage scales of skilled craftsmen in the building trades, and feel that these high wages are boosting the cost of his housing. The skilled workers, organized in strong unions, and receiving high rates of pay, may be indifferent to the struggle by semiskilled and unskilled workers to improve their wages and working conditions. Thus, in any specific situation, those workers who are not directly involved, along with businessmen, farmers, and the government, may be considered as part of the general public. Their attitudes may be affected strongly by the fact that they also work for employers and receive wages and that they may have faced or still face similar problems. They may, however, hold views quite different from those of the immediate parties to the dispute. They represent part of public opinion. The skill with which each side in a labor dispute presents its case to the public is often a factor of great importance.

To the public, or community as a whole, problems of labor have great significance. That is why the government has come to play such an important role in matters of wages, hours of work, working conditions, and labor disputes.

The welfare of the community depends upon the level of production.

Efficient, contented labor, at peace with management, makes for higher levels of production at lower costs. The level of wages has an effect upon the level of business activity. The failure of wages to rise adequately may restrict consumer purchasing and cause contraction of business enterprise. A rapid rise of wages may cause higher prices for goods and services, or may have the effect of reducing rates of profit to the point at which investment and enterprise is discouraged.

Dissatisfaction among workers may lead to strikes, accompanied by mounting tempers, hatred, propaganda warfare, and physical violence. The agencies of government have been brought into labor disputes in attempts to settle them peacefully. Sometimes the government has used police and military forces or the power of the courts in order to protect business property. Labor disputes have entered into the political arena, and political parties have made labor problems major issues in their campaigning. Organizations of workers and of employers have both used political tactics in their conflicts with each other.

From the point of view of the community, the problem is how to bring about that understanding between labor and management which will make for peace, production, and plenty.

### Exercises and Activities

I Dictionary of Economic Terms

| | |
|---|---|
| labor | management |
| labor force | wage earner |

II Questions and Problems

1) Classify each of the following as labor or management: (a) stenographers, (b) policemen, (c) druggists, (d) newspaper publishers, (e) newspaper editors, (f) teachers, (g) the board of directors of a corporation, (h) the officers of a corporation, (i) the mayor of your city.
2) "Wages are both a cost and an income." How does this affect the relationship between businessmen and workers?
3) Name four major labor problems.
4) "In America there is no such thing as a permanent working class, with separate interests from any other class." Discuss.
5) (a) "Labor need not worry about public opinion, because the public is made up mostly of workers." Explain why you agree or disagree with this statement. (b) Why is the public concerned with the proper solution of labor problems?
6) A newspaper advertisement once asked, "Who is the public?" How would you answer this question if you were (a) the head of a union

engaged in a strike, (b) the head of a business firm whose workers were on strike, (c) a consumer of the article produced by the workers engaged in the strike, (d) the President of the United States?

III Things To Do

1) Interview several people; if possible, a worker, a businessman, a farmer, a professional man, and a housewife. Find out whether they generally take the side of one party in a labor dispute. Get their reasons.
2) Secure the latest figures for the groups in the American labor force shown in the chart on page 436.

# *LESSON* 57 THE BASIS OF WAGES

## Wage Rates and Earnings

*Wages* are a price paid for labor. A *wage rate* is the sum paid per unit of goods produced, or per unit of time worked. If the worker is paid on the basis of a definite amount per unit of goods produced or worked on, he is being paid on a *piecework basis*. A window cleaner, for example, may be paid 25 cents for each window he cleans. If the worker is paid so much per unit of time spent, he is being paid on a *time basis*. Such a wage rate may be stated as so many cents or dollars per hour, per day, per week, or per month. In the case of professional and executive workers, contracts for labor may set forth an annual salary.

Where the method of wage payment is by the piece, the employer has the advantage of knowing his labor cost per unit produced. The fact that total earnings can be increased only by increased output may act as incentive to the worker. Workers often object to piecework payment, however, because they feel that the employer can set the piece rate so low that the worker must work too fast in order to earn a decent wage. This creates a situation referred to by workers as a *speed-up*. They claim that in many cases high production and high earnings have been a signal to employers to reduce the wage rate per piece. Workers have objected to piece rates also because the speed at which they can produce often depends upon factors beyond the workers' control, such as breakdown of machinery, or interruption of the flow of materials. Only where the unions of workers have been strong enough to control their rates, as in the clothing industry, have piece rates been preferred.

Payment on a time basis has generally been preferred by labor because it involves less strain and less chance of a speed-up. To the em-

ployer, a time basis of payment means greater difficulty in determining labor cost per unit produced. Efficient operation and good labor relations, resulting in large volume, will mean a lower cost per unit of production than inefficient operation and strained labor relations. The fact that the rate paid per week is the same, regardless of output, may stimulate employers to provide the most efficient machines, and to have materials flowing to workers in a steady stream.

Generally speaking, the longer the period on which the wage is based, the greater is the worker's security. The worker who has a contract agreeing to pay him a stated amount for one year's work is secure in the knowledge that he will have that income for the year. Hence one of the demands of labor in recent years has been the *guaranteed annual wage.* This means a guarantee by the employer of a minimum number of weeks of work during the year. A few hundred firms have tried this scheme. Although labor favors it because of the increased security it gives, employers are wary of any proposal that makes labor cost a fixed cost, which cannot be easily adjusted to changes in the volume of production.

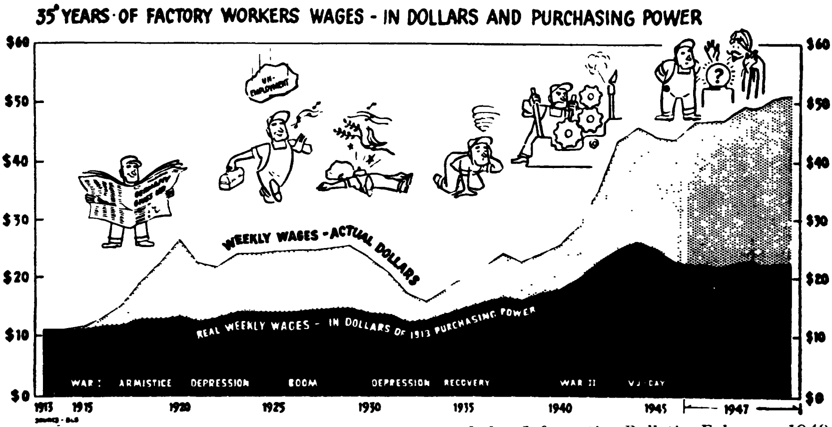
In some business firms there have been experiments in *profit sharing.* Profit sharing provides for an additional bonus to employees when profits rise higher than a specified level; the amount of the bonus for each worker is usually based on wages and length of service. The aim is to make the worker feel that he profits, along with the owners, from increasing efficiency. Labor has not been enthusiastic about such plans, on the grounds that when the employer is in financial difficulty, he will feel justified in suggesting that wages be cut to make up for losses.

The fact that employment may bring with it benefits other than a money wage must not be overlooked. Many firms provide recreational facilities, pensions, life insurance, and other advantages, which, though not part of the wage, are considered by workers in weighing the attractiveness of the job. Unions have, in recent years, placed increasing emphasis on the establishment of pension and welfare systems.

Experiments have been made with agreements between workers and employers that wage rates be automatically raised or lowered as the cost of living rises or falls. Labor has generally opposed such schemes, on the ground that it makes for a static level of real wages, and prevents the improvement of the workers' standard of living. The 1947 contract between General Motors and the United Automobile Workers' union provided for such an arrangement on a modified basis. Wages were to be adjusted to changes in cost of living, but a special annual increase was provided for in order to make possible a rise in the real wages of the workers. This arrangement was renewed in the 1950 contract.

A high wage rate does not necessarily mean high earnings. The level

of earnings depends not only on the wage rate, but also on the amount of time spent at work. Many people are misled by high hourly rates, in such occupations as mining or the building trades, into believing that total earnings are necessarily at an equally high level. When industries are *seasonal,* busy during part of the year only, the time worked and the total earnings may be moderate or even low, despite high wage rates.




Labor Information Bulletin, *February, 1948*

A glance reveals that real wages in 1947, despite some decrease from the high in 1944, were considerably higher than in 1913, the so-called "good old days." Note that real wages declined slightly in 1947, while money wages rose. What must have happened to the cost of living?

PRODUCTIVITY AND WAGES

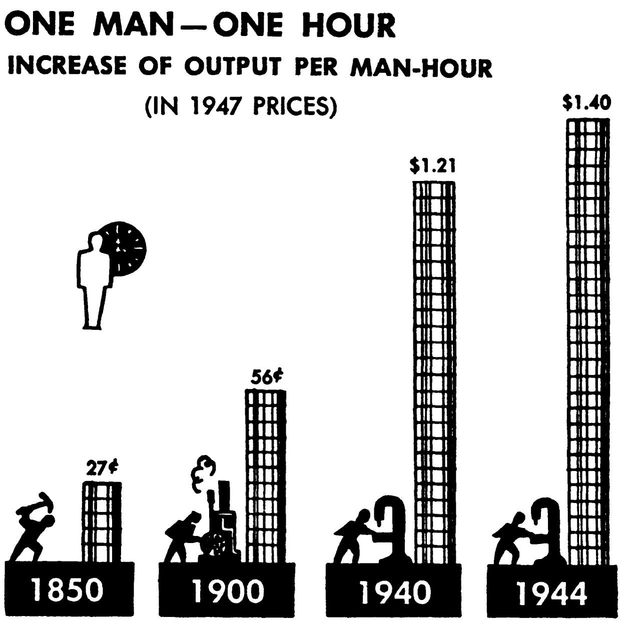
To the employer of labor, workers are a factor of production, to be combined with other factors, such as land, buildings, machines, and materials. Because of its contribution to the production of goods and services, labor receives about two-thirds of the national income; and this huge amount is divided among tens of millions of workers. The money received by the workers of this country constitutes a huge pool of purchasing power. But, as has been pointed out in earlier lessons, it is *real wages*—the amount of goods and services which money wages can buy—that determines the workers' standard of living.

Over a long period of time, real wages are determined chiefly by *productivity;* that is, the amount of goods or services produced per *man-hour.* A man-hour is the work done by one man working one hour. Thus, eight man-hours of work result from one man's working eight hours, or from two men's working four hours, or from a number of other possible combinations. Increased productivity is made possible by the improvement in the skill of the individual worker, and by the use of more machinery and more systematic methods of production. The worker today

is physically more fit, better educated, and more attuned to systematic working procedures than was the worker of previous generations. Businessmen invest large amounts of capital in plant and machinery, in order to get larger profits by increasing the productivity of their workers. This development of better methods of production has enabled businesses to lower cost per unit, do a larger volume of business, and make more profits. More profits make possible higher wages.

The economic development of the United States has been noted for its tremendous technological development, and for the high productivity of labor. This fact is illustrated in the chart which follows. The chart shows the increase in labor productivity over a hundred years. Labor productivity per man-hour in 1944 was over five times what it was in 1850. During this period there was an accompanying increase in investment per worker; this is shown in the graph on page 231. The fact that real national income also rose is evidenced in the graph on page 65. Labor's gain in rising productivity is shown by rising real wages; the rise from 1913 to 1944 is revealed in the graph on the opposite page.

Technological progress and higher labor productivity make it pos-




HARRY A. HERZOG FOR THE PUBLIC AFFAIRS COMMITTEE, INC.

**In the fifty years from 1850 to 1900 the productivity of labor more than doubled. In the next forty years it more than doubled again. Constantly increasing productivity has been a major factor explaining constantly rising standards of living.**

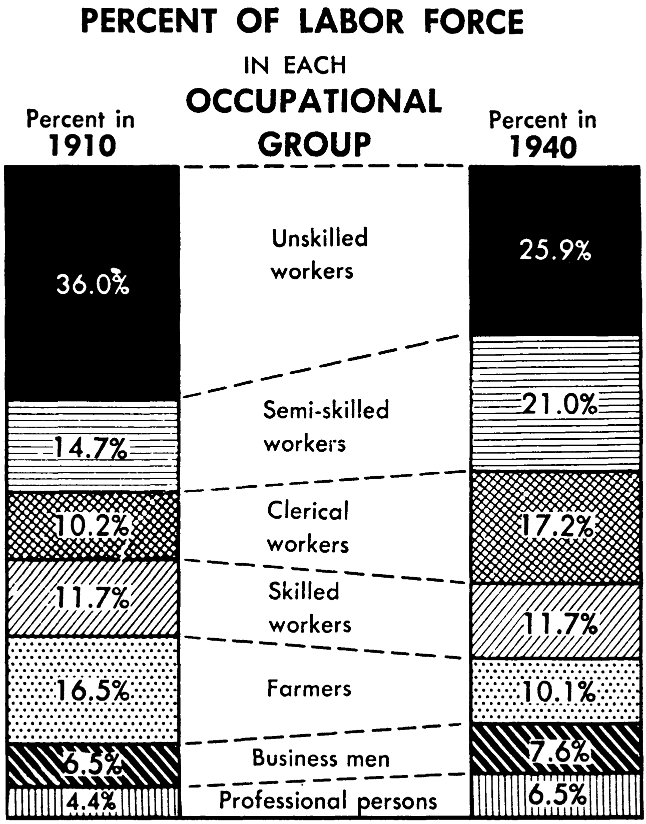
sible for businessmen to pay higher wages without increasing the prices of their goods. This does not prove that a wage increase is always possible without increasing the prices of goods. The businessman is in business to make a profit, and his selling price must more than cover his costs. If a wage increase means increased cost per unit, he will have to raise prices or accept lower profits. However, where machinery is used and mass-production techniques followed, an increase in volume of output may reduce unit costs by spreading overhead cost over a greater volume of production. If production is below capacity, a wage increase can be offset by an increase in production. The wage increase may be paid out of increased productivity, rather than out of increased prices or lowered profits. If production is already at capacity—as was true for many businesses during the war years—a rise in wages may make necessary a rise in prices, if profits are to be maintained.

### Factors Determining Wage Rates

The wage paid for a particular kind of labor is, like other prices, determined by supply and demand. The *supply of labor* is the number of workers of particular kinds available at a given time. The *demand for labor* depends on the number of jobs of particular kinds available at the time. A decline in labor supply, or an increase in demand for labor, tends to raise wage rates; an increase in labor supply, or a decrease in demand for labor, tends to cause a fall of wage rates. Thus, during the war, the number of workers available for many types of skilled jobs was reduced, because the needs of the armed services for men reduced the labor supply. At the same time, the huge increase in production swelled the demand for labor. The wartime situation caused employers to raise wages to attract workers.

The supply of labor does not consist of a mass of people all of whom are capable of performing any type of labor. As the chart on page 445 shows, labor is divided into groups of skilled, semiskilled, unskilled, clerical, manual, and professional workers. Each group is divided into particular occupations, requiring different levels and types of training or experience. If, for example, the supply of electricians is too small, it is not possible for other workers to shift immediately into that occupation, to take advantage of rising wage levels. The period of training may be lengthy, and many workers may not like, or be suited for, that kind of work. Labor, therefore, consists of many *noncompeting groups* of workers. Workers in skilled occupations do not face the constant threat of immediate competition from other types of workers. On the other hand, unskilled and semiskilled workers can shift only from one kind of unskilled or semiskilled work to another.

There is also a resistance to shifting from one place of occupation to




Almost two-thirds of the labor force in 1940 consisted of unskilled, semi-skilled, and clerical workers. Technological advances seem to have decreased the proportion of unskilled workers while increasing the proportion of semi-skilled; the proportion of skilled remained constant. (Data from Twentieth Century Fund)

another. Workers will move to new parts of the country to take advantage of new opportunities; but the process ordinarily is slow, because it is expensive, and involves leaving accustomed locations and people. Various kinds of discrimination make it difficult for some people to shift into better jobs. This tendency to resist change of occupation is often referred to as the *immobility of labor.* The fact that labor is fairly immobile means that the wage rate for a particular occupation depends upon the supply of a given type of labor at a given time and in a given place rather than upon the supply of labor in general.

### The Demand for Labor

Several important factors have affected the demand for labor. The demand for labor has grown along with the development of the country

from a tiny agricultural land to a great industrial nation. With the growth of population, the increasing use of the natural resources, and the establishment of new industries, more jobs have been created.

The long-run expansion has not moved at an even pace, but has been affected by periodic changes in economic conditions. During periods of prosperity, opportunities for profits are great, and businessmen venture into new enterprises. In this way the businessman makes jobs for his own employees, and for the workers in the businesses which supply him with materials and equipment. Depressions limit the opportunities for profit and the demand for labor. It must be remembered, however, that the demand for workers does not vary at an even rate for all kinds of work. The demand varies from industry to industry, from one place to another, and from one kind of work to another, according to a great variety of factors.

The demand for labor is also affected by technological changes, that is, inventions or other changes in the methods of production. Thus, the invention of a bottling machine reduced the demand for glass blowers, while it increased the demand for machinists and steel workers. The net effect of technological progress upon the demand for labor depends upon whether the number of jobs created is larger or smaller than the number of jobs eliminated.

The demand for specific kinds of workers is affected by *seasonal fluctuations* in particular industries (see pp. 466 and 623).

Changes in style and consumption habits, too, affect job opportunities. If ladies' hats are decorated one year with costume jewelry and another year with feathers, there are corresponding changes in the demand for labor in the jewelry and feather industries. The development of modernistic styles of furniture increased the use of chromium and steel, and helped to create more jobs in the steel industry.

### The Supply of Labor

The number and the kinds of workers available depend on a variety of factors. General economic conditions are very important. During a period of full employment, the supply of workers is small relatively to the demand. Some of them leave low-paying or less pleasant kinds of work for jobs which are more comfortable and better paying. Often, when earnings of the family's breadwinner are high, fewer people in the family go to work; housewives stay at home, and young people continue their education. This withdrawal of workers reduces the supply of labor, and enables the remaining workers to get more for their services. When times are bad, the situation is the opposite. The supply of labor is greater than the demand for labor, and workers

compete with one another for jobs. This competition is increased by the entrance into the labor market of additional workers, to help increase their families' incomes. Workers are therefore forced to take whatever jobs they can get, and wage rates are cut.

An important factor in the labor supply is the growth and shifting of population. The advancement of medical science has increased the span of life, and has increased the labor supply, especially of older workers. Migrations of workers from one country to another, or from one section of a country to another, or from one industry to another, also affect the supply of labor and therefore wage rates. The huge flow of immigrants into this country during the period between the 1840's and World War I helped to provide a large supply of cheap labor, and limited the rise of wages. When many young people left the farm for city life (graph on p. 390), the supply of factory and white-collar labor increased accordingly. During World War II, tens of thousands of workers shifted from their normal jobs to the airplane plants and shipyards of the West Coast and the South. American labor unions have opposed large-scale immigration into this country, because they fear that an increased labor supply would keep down wage rates.

The supply of labor is also affected by social standards as to who ought to work, and as to what kinds of work are desirable. We have become accustomed, for example, to having married women work. In recent times there has been a drift toward white-collar types of work—clerical work, selling, professional—because these types of work, in the minds of some, bring a higher social status than manual labor. This has greatly increased the supply of white-collar workers and limited the supply of mechanics and craftsmen. During the 1940's this neglect of skilled trades was reversed, because of the high wages of skilled workers of all kinds.

Government regulation is becoming increasingly important in determining the supply of labor. Compulsory-education laws and other government regulations have greatly reduced the number of boys and girls in the labor market. The employment of women and children in jobs which are too dangerous or strenuous is forbidden. Standards and licenses have been established for various kinds of skilled workers, such as electricians, plumbers, and dental mechanics. The standards tend to limit the number of workers in these fields. Laws have also been passed by federal and state governments to help workers organize *labor unions* (see p. 526).

As you will see in Lesson 62, labor unions are an important device for controlling the supply of labor and for keeping up wages. For a long time the carpenters, plumbers, electricians, machinists, and other such

skilled craftsmen were the leaders in the union movement, and were the leaders in raising wage standards. In recent years trade unions have spread into many fields of semiskilled and unskilled work.

A major factor influencing the supply of a particular kind of worker is the nature of the work. In general, the greater the amount of skill or training required, or the more strenuous or dangerous the work, the smaller the supply will be, and the higher the wages and salaries. Business executives and professional people may not work as hard physically as other people, but their supply is relatively limited, because of the intelligence, skill, and personality required. Employers have to pay higher wages and offer special inducements such as insurance benefits, to the "sand-hogs" who dig tunnels, and to the various kinds of miners, because of the high rate of accidents and illnesses.

It would be wrong to conclude that labor has its wages determined exclusively by the operations of supply and demand, like an ordinary article. Labor consists of human beings, and wages are incomes of individuals, not just a price for services. Low wages may mean low costs and low prices, but they also mean low income, low standards of living, poor education, poor health, poor morale, and general discontent. In the Clayton Act of 1914, the federal government stated the principle that "the labor of a human being is not a commodity or an article of commerce."

The federal and state governments in many ways have shown a concern about the level of wages and the conditions of work. Minimum wages and maximum hours have been set. The conditions of employment, particularly for women and children, have been subject to regulation. The right of workers to organize unions to better their conditions has been recognized.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| demand for labor | noncompeting groups | speed-up |
| guaranteed-annual wage | piecework basis | supply of labor |
| immobility of labor | productivity | time basis |
| man-hour | profit sharing | wage rate |
| | real wage | wages |

### II Questions and Problems

1) In parallel columns list the factors which affect (a) the supply of labor, (b) the demand for labor.
2) Account for the following differentials in wages: (a) a carpenter receiving a higher weekly wage than a bookkeeper; (b) carpenters in

one town receiving a higher wage than carpenters in another town; (c) a star baseball player earning more than the highest-paid college president; (d) a "sand-hog" earning more than a stenographer.

3) The American worker has a much higher standard of living today than he had fifty or one hundred years ago. List the demand and supply factors that have affected his wages.
4) In an attempt to define the phrase "a living wage," this statement has been made: "It all depends on whether you're receiving or paying it." (a) Explain this statement. (b) How does this reflect one of the problems in labor-management disputes?
5) (a) Summarize the various methods of wage payments described in this lesson. (b) Which of the methods of wage payments do you consider most desirable? Why?
6) Show how the immobility of labor preserves the existence of non-competing groups.
7) "The labor of a human being is not a commodity." Explain this statement, and show how public policy has been affected by this idea.
8) "Over a long period of time, real wages are determined chiefly by productivity." (a) Explain this statement. (b) Comment upon the statement from the viewpoint of labor and management.

## III Things To Do

1) Draw a graph based upon the following figures:

Earnings of the Average Non-farm Employee. 1890–1946

| | *Full-time Equivalent Earnings** | *Money Earnings* | *Real Earnings (1910–14 dollars)* |
|---|---|---|---|
| 1890–94 | $ 553 | $ 502 | $ 636 |
| 1895–99 | 542 | 468 | 597 |
| 1900–04 | 590 | 554 | 644 |
| 1905–09 | 641 | 597 | 647 |
| 1910–14 | 700 | 649 | 649 |
| 1915–19 | 978 | 918 | 678 |
| 1920–24 | 1,392 | 1,235 | 682 |
| 1925–29 | 1,492 | 1,384 | 781 |
| 1930–34 | 1,307 | 950 | 640 |
| 1935–39 | 1,366 | 1,103 | 721 |
| 1940–44 | 1,910 | 1,763 | 1,066 |
| 1945–46 | 2,508 | 2,408 | 1,261 |

* "Full-time equivalent earnings" are the earnings a wage earner would receive if he worked full time, with no loss of income due to unemployment. (Adapted from the New York Times.)

2) Secure the figures which will bring the above table up to date. Possible sources are *Monthly Labor Review, Statistical Abstract of the United States,* and special bulletins of the United States Department of Labor.

3) Answer the following questions based on the above table: (a) Why are the figures in the second column always lower than those in the first column? (b) What is the base period for computing real earnings? (c) Why are the figures in the third column sometimes lower and sometimes higher than those in the second column? (d) Between 1925–29 and 1930–34, how did full-time equivalent earnings change? How did earnings change? Account for the great discrepancy in these two changes. (e) From 1890–94 to 1945–46, by how many times did money earnings increase? Real earnings? Account for the difference in rate of increase.
4) (a) In your own community find examples of at least three noncompeting groups of workers. (b) Find out what they earn. (c) Try to account for any differences in earnings.
5) Find out the details of the General Motors wage system, or of some other similar "pegging" system.
6) Read and report on (a) *Guaranteed Wage Plans in United States,* a report issued in 1948 by the federal government. (b) *Money Value of a Man* by L. I. Dublin and others (Ronald, 1947). (c) *Basic Criteria Used in Wage Negotiations* by S. H. Slichter (Association of Commerce and Industry, 1947).

# *LESSON* 58 HOURS AND WORKING CONDITIONS

## Reducing the Hours of Work

The descriptive term "sweatshop" has been used to describe a place in which conditions of work are far below standard. Here is a quotation which describes sweatshop conditions in the clothing industry at the beginning of the century:[1]

### The Garment Industry, 1900

Sweatshops were everywhere, perched in lofts over stables; concealed in dark, rat-infested cellars; stuffed into the bedrooms and dark hallways of slum dwellings. There were no washrooms, no drinking water; gas jets burned day and night. On July and August "dog days" the workers, carrying their work with them, sought fresh air on roofs and fire escapes.

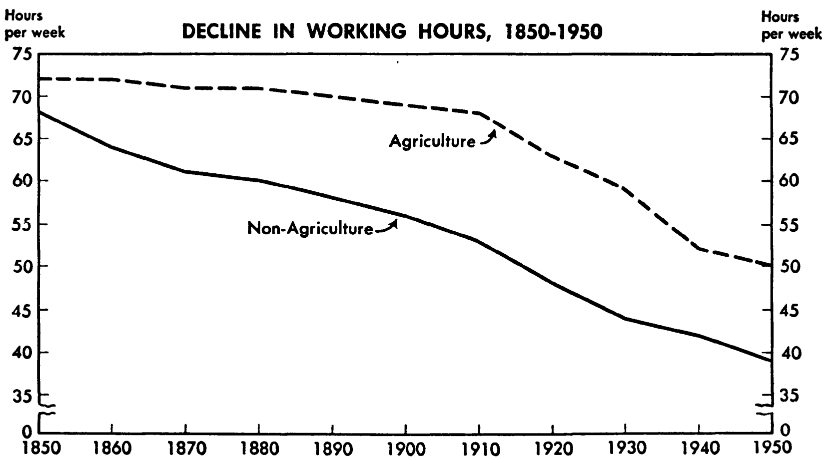
Older workers toiled from 60 to 80 hours for a weekly wage of $5 to $6. Young men and women, classified as "learners," worked for $1.50 to $3. The work week included Saturday and part-time on Sundays. In the busy season men frequently worked all night and put in a full day on Sunday. Pitted

[1] Excerpt from ". . . *and the Pursuit of Happiness,*" Educational Department, International Ladies Garment Workers Union.

against each other, workers paid for the use of sewing machines, thread and needles and the very chairs on which they sat.

The factory system had hardly developed before people began to protest against the long hours and unhealthy working conditions. Workers demanded that the government limit the hours of work. Employers resisted these demands because they feared that a shorter working day would reduce production and profits. They argued that a shorter workday would create the opportunity for mischief and moral delinquency. In the United States, limiting hours of work by law was hindered by the fact that each state could make its own laws. In each state, therefore, the factory owners feared that if their state passed such laws, they would be unable to compete with manufacturers in states permitting longer hours. Furthermore, there was the question of the possible conflict of these laws with the national and state constitutions.

The regulation of hours of work has been established, through union contracts, and through federal and state laws. At first, hours were limited only for women and children, and for men in dangerous jobs like mining. By the time of the War Between the States, government employees, and many craft workers, had achieved a 10-hour day, but most factory labor still worked about 12 hours per day. Progress in the reduction of the work week is shown in the chart below.




**Note that hours in both farming and industry have decreased but that the rate of decrease has been greater in nonfarming occupations. What factors may help to explain this? (Data from Twentieth Century Fund)**

Although the campaign for the 8-hour day began soon after the War Between the States, the 10-hour day was still standard at the beginning of the twentieth century—except for the building-trades workers.

Not until the 1920's was the 8-hour day generally accepted. In the 1940's, the 40-hour week became widely established, along with a definite tendency toward a 5-day week.

The debate over reducing the workday and work week (without reducing daily and weekly earnings) is still going on between labor and management. Those who favor reduction of the working day point first to its effect in improving the health of workers. Second, they claim, a shorter workday can mean greater efficiency and more production. Studies made during the past generation indicate that it is possible, despite the shorter workday, to maintain or even increase production, up to a certain point. This is partly the result of reduced fatigue and monotony. It also results from reduction in *absenteeism*, by which we mean frequent absence from work, which interrupts output, reduces efficiency, and increases costs. Third, the shorter workday stimulates technological improvement. Employers try to offset the shortening of hours by making the work more systematic and by introducing more and better machines. Fourth, the shorter workday and work week create business. People have more leisure, and therefore spend more money for motion pictures, baseball, and other forms of entertainment and recreation. Fifth, this leisure gives the people time for cultural activities and for participating in civic activities. This means a better-educated and more active body of citizens—a vital need in a democracy. Sixth, limiting the number of hours worked by each employee helps to spread employment. This is particularly important when business slows down and jobs become relatively scarce.

Businessmen today generally grant the force of these claims, but they maintain that there is a limit to the gains. Reducing hours of work beyond a certain point, soon reached, means reducing production. This means fewer goods and lower standards of living, or higher costs and higher prices. Up to now the reduction of hours in American industry has been absorbed with little difficulty, because of the extraordinary development of technology and rising productivity. But this process cannot continue forever. There is a limit to increasing productivity by technological improvement. Besides, workers often oppose improvements in methods of production because they fear unemployment.

### Industrial Illness and Accidents

A decade ago a newspaper published a story about a "village of living dead men." The story told of several hundred men waiting for death, after having contracted silicosis while digging a tunnel through a mountain. No masks had been provided for them while they drilled through the rock, nor had water been used to keep down the dust. Stories of this kind are shocking; but they help to remind us that we have

paid, and are still paying, a high price in illness and accidents, injury and death—in human suffering—for the industrial system which we have developed.

Millions of American workers are in occupations in which one or more diseases are a definite hazard. Perhaps the most widespread problem is dust, such as is given off in foundry work, grinding of tools, metal and jewelry polishing, quarrying of stone, manufacture of glass, and in mills using cotton, felt, wool, tobacco, flour, and paper. In certain chemical industries the health of some workers is gradually harmed. Workers in tanneries must guard against anthrax. Those who work under extreme pressure, as in the building of tunnels, are exposed to various types of illnesses. The artificial dampness required in textile mills make textile workers susceptible to tuberculosis.

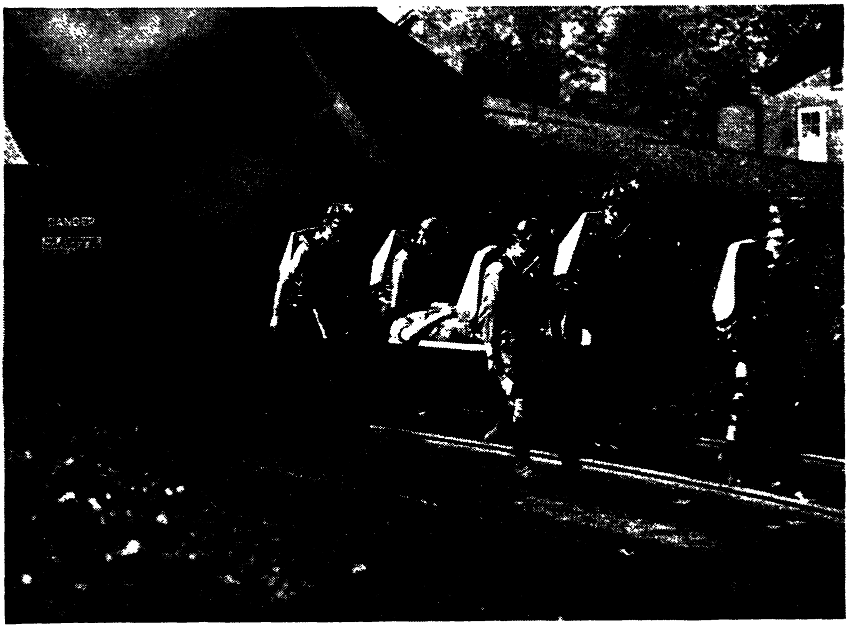
In addition, every year there are over 2 million industrial accidents in this country. Over 20,000 of these accidents are fatal. The number of accidents varies from one occupation to another; probably the worst record is found in mining. The United Mine Workers Journal once published statistics for the coal mines showing that over the previous 50 years, the average number killed by accident had been over 2000 per year, and the number of injuries had been over 100,000 per year.

These industrial illnesses and accidents are in addition to the ordinary illnesses which occur among workers as among everybody else. Studies show that there is proportionately more disease among unskilled, low-income workers than among business and professional people and skilled workers.

Industrial illnesses and accidents are traceable to a variety of causes. To some extent they result from bad working conditions, some of which are avoidable, while others are not. Machine work combines monotony and speed, and thereby increases nervous strain. In many factories and offices the noise is great enough to add to the nervous strain. Lighting may be too little, too much, or poorly arranged. Temperature, humidity, and ventilation also affect the skin, lungs, blood pressure, and nervous reactions of the workers. Dirt, unscientific arrangement of machines and workbenches, and unsanitary drinking and toilet facilities endanger workers' health. Industrial accidents and illnesses are also caused by the workers' own negligence. Sometimes they handle tools and machinery carelessly, and neglect the use of proper safety devices. Rules for good health are violated by workers, as by the rest of the population.

It is difficult to measure accurately the cost of industrial accidents and illness to this country. We know, however, that the cost amounts to several billion dollars a year. Work is interrupted, many workers are below their normal efficiency, and new workers have to be trained to replace those who are sick or injured. Large amounts have to be spent

by companies for accident-compensation insurance, and for workers' sickness and death benefits. Millions of workers suffer some loss of income, and have to pay for medical expenses. In addition, there is damage, in terms of broken careers and suffering families, which cannot be measured in money.



*Bureau of Mines*

**A fully equipped rescue crew carries an accident victim from a coal mine. Mining has been among the most hazardous of American industries.**

### Improving Workers' Health and Safety

There is no easy solution for the problem of the workers' health and safety. Precautions against disease and injury cost money—improved ventilating equipment and lighting fixtures; scientifically arranged workbenches, conveyor belts, and assembly lines; special types of masks, goggles, gloves, and shoes; medical attendance and first-aid facilities. All these safety measures mean, in the short run, higher costs for the businessman, lower profits, and greater difficulty in meeting competition. Many businessmen therefore hesitate to spend the money for safety measures except when times are good, or until they are forced to adopt such measures by pressure from insurance companies, labor unions, or public agencies. Usually it takes a headline disaster—a bad fire, a mine explosion, or a shocking exposure like the story of the "living dead men"—to arouse the public enough to get stricter laws or bet-

ter enforcement of existing laws. Improvements therefore come in spurts.

In spite of these difficulties, much progress has been made. Many business firms have found that, in the long run, safety measures reduce, rather than increase, production costs. This fact results from the increased productivity of healthy workers, from the minimizing of absenteeism, and from the reduction in insurance costs.

Many labor unions, in their contracts with employers, have included


*Standard Oil Co. (N.J.), photo by Corsini*

**Safety equipment reduces occupational hazards. This man is a pumper, gauging tanks of crude oil rich in sulphur. He is required by law to wear a mask.**

rules about working conditions as a means of protecting the workers' health and safety. One of the chief accomplishments of organized labor in this country has been in securing the passage of laws regulating working conditions and protecting the health and safety of working people. In general, these laws, varying in the forty-eight states, make the following provisions: (1) women and children may not be employed in certain kinds of strenuous or dangerous work; (2) ventilation, lighting, temperature, and handling of poisonous materials are regulated; (3) guards and other safety devices must be provided for belts, gears, and other moving parts; (4) in certain kinds of work the company must provide goggles, masks, and other safety equipment; (5)

protection against fire must be provided—adequate exits, fire-fighting equipment; (6) minimum standards of sanitation are set for toilet and washing facilities, drinking water, space for eating, first aid; (7) hours of work must be shorter for strenuous occupations.

It is generally recognized that in the field of industrial safety, education is very important. Government agencies and insurance companies have issued numerous pamphlets and other publications, in an effort to make both employers and workers more safety-conscious. Trade and vocational schools teach shop safety, and the actual use of machines is withheld until each pupil passes his safety test.

Modern science has also contributed to industrial safety. Medical research has taught us much about the prevention and treatment of such diseases as silicosis and tuberculosis. Health departments maintained by communities, by employers, and by unions are able to prevent, as well as cure, ailments which previously were neglected.

### Workmen's Compensation

It would, of course, be most desirable to prevent industrial accident and occupational disease. It is not likely, however, that all industrial sickness and injury can be avoided. Hence, it has been found desirable to provide a system of easing the financial problems and worries of those who become sick or who are injured as a result of the work they do. This is provided by *workmen's compensation laws*, which now exist in forty-seven states.

Compensation is a payment of money to a worker injured on the job, or to the family of a worker killed on the job. Before special workmen's compensation laws were passed, the worker had to sue his employer. He had to prove not only that the employer was negligent but also that neither the injured party nor a fellow worker was guilty of contributing to the injury by negligence. Workmen's compensation laws make such procedures unnecessary. They specify that, for accident or illness on the job, specific payments be made to the worker or his family. Employers carry insurance with a private company or state agency, which pays the compensation benefits. This guarantees that a worker will receive his benefits, regardless of the financial standing of the employer.

Although they are not aimed primarily at prevention, workmen's compensation laws have helped to reduce the occurrence of industrial accidents. The educational activity of insurance companies has encouraged better safety precautions. The use of an *experience-rating* plan in fixing insurance premiums has also had some effect. This means that the employer with a good record pays a lower premium than one in whose plant accidents are frequent. This plan, coupled with the fact that rates are often based on an inspection of working conditions and

safety precautions, acts as an incentive to eliminate possible causes of accident.

### Exercises and Activities

I Dictionary of Economic Terms

absenteeism workmen's compensation
experience-rating

II Questions and Problems

1) How does the chart on page 451 illustrate the effects of the industrial revolution?
2) (a) Summarize the arguments in favor of reduced hours of work. (b) Is there a limit to the possible reduction of hours? Discuss.
3) Name the major causes of industrial illnesses and accidents.
4) List five important types of laws regulating working conditions.
5) Why are many employers in favor of improved working conditions?
6) How do workmen's compensation laws (a) compensate for illness and injury, and (b) help to prevent them?

III Things To Do

1) Write a report about silicosis: causes, results, and attempts to overcome the disease
2) (a) Review the discussion of scientific management on page 234. (b) How does it improve working conditions? (c) Why do workers claim that it sometimes leads to the speed-up and the stretch-out?
3) Read the government pamphlet, *Butch Learned the Hard Way*, a popular presentation of basic safety rules for workers.
4) Write a brief essay on how the novels of Charles Dickens or Arnold Bennett helped to expose bad working conditions.
5) Read and report on Chapter 9 of *The American Story of Industrial and Labor Relations* (published by the New York State Joint Legislative Committee on Industrial and Labor Relations, 1943).

## *LESSON* 59 THE PROBLEM OF SUBSTANDARD WORKERS

### Why Substandard Workers Are a Problem

As we investigate the conditions of particular working groups, particular areas, or particular industries, we note that some groups of workers do not, on the average, fare so well as others. *Substandard workers* are those whose wages and working conditions are below socially acceptable standards.

Despite increasing acceptance of the principle of "equal pay for equal work," some workers find it harder to get jobs and may therefore work longer hours for lower rates of pay. Children under sixteen and women frequently work for lower wages than men doing the same work. Immigrants, in the years when immigration was important, were employed at less than standard pay and under substandard working conditions. Negroes still find themselves unable to compete equally in the labor market.

The existence of a large group of workers who find it necessary to accept lower standards is a threat to the standards of all workers. The substandard workers are forced by economic necessity to engage in a sort of cutthroat competition with each other and with other workers. In good times, this competition may not be very noticeable. When business slows down, and the demand for labor shrinks, it may become a factor of importance. Employers, faced with the need for cutting costs, are able to use the ever-present group of low-wage workers as a means for cutting wages.

The low wages of the substandard workers means a low standard of living, poor health, and inferior education. The costs of public relief and health services are often a drain upon the community pocketbook.

### Factors Causing Substandard Conditions

Why are some groups of workers substandard? The first reason may be inability to handle better jobs. Some occupations are not open to women and children, because women and children lack the necessary strength and physical endurance. Forced to concentrate on a limited number of job areas, women and children tend to accept lower wages and poorer working conditions.

A second reason for substandard groups is social custom. Certain jobs are still regarded as unsuitable for women. Some racial, religious, and national groups suffer from discrimination. Immigrants, accustomed to the low wages and living standards of other areas, are willing to accept low wages and hard work, until they become acquainted with American standards.

Geographic factors are also important. Regions where soil is eroded, where mines have been worked out, where timber has been cut—regions whose resources have disappeared—tend to be areas of low wage standards. Immobility of labor makes the migration of workers a slow process. Job opportunities disappear, and a problem area of substandard workers results. This was true in some regions of New England, when the shift of the textile industry to the South left large numbers of skilled textile workers high and dry. In the South, the presence of a large Negro population was a factor in creating a large substandard

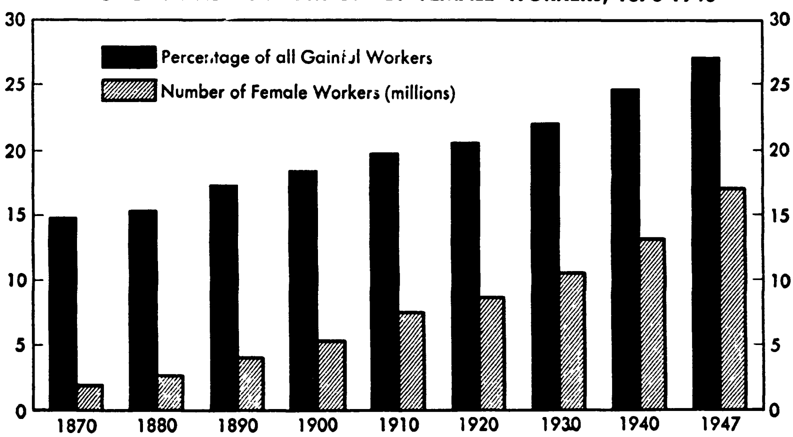
group. Accompanying this was the erosion of soil in many parts of the Southeast, making for a poor farming group. The breakdown of the plantation system and the introduction of a system of sharecropping produced a group of substandard workers.

Another factor has been the absence of effective labor organization among substandard workers. Generally unskilled, they are most easily replaceable, and therefore they have the greatest difficulty in making their organizations effective. Often subject to prejudice, they have not been readily accepted on an equal basis in existing unions.

### Women Workers

The growing importance of women in the labor force is shown in the following graph. Women's pay is generally below that of men who do the same work.

**NUMBER AND PROPORTION OF FEMALE WORKERS, 1870-1940**




**Women have played an increasingly important role in industry. The solid bars in the chart show an increase in the *percentage* of women workers; the shaded bars show the increase in actual *numbers* of women workers. In what ways has this affected family life? What changes in our way of living have made this increase possible? (Data from Twentieth Century Fund)**

Fortunately much progress has been made, particularly between 1930 and 1950. World Wars I and II helped to broaden job opportunities for women. Because men were needed for military service and for essential civilian work, women took over a great deal of the clerical work in offices and stores, and also many kinds of mechanical work which hitherto had been done by men. The spread of free public education in the 1920's and 1930's gave women more opportunity to secure more industrial, commercial, and professional training. The improvement of trans-

portation and the simplification of housework made it easy for many women to combine full-time or part-time work with their housekeeping duties.

At the same time that women have found more types of employment open to them, their status has improved in many other ways. To a large extent this has been the result of special protective legislation. Since the passage of the Massachusetts ten-hour law in 1879, almost every state has established some limitation on daily and weekly hours for women. Many states prohibit night work by women (usually after ten P.M.), and some require definite rest periods. Most states forbid (in varying degrees) the employment of women in dangerous and undesirable industries, such as mines, foundries, and factories having dangerous machinery.

The large wartime demand for their services gave women an opportunity to establish the principle of equal pay for equal work. Labor unions welcomed these millions of women into membership and established the principle that pay should be based on the kind of work done, regardless of sex. The wartime regulations of the federal government also recognized this principle, and the State of New York, in 1944, passed a law prohibiting employers from paying women less than men for the same type of work.

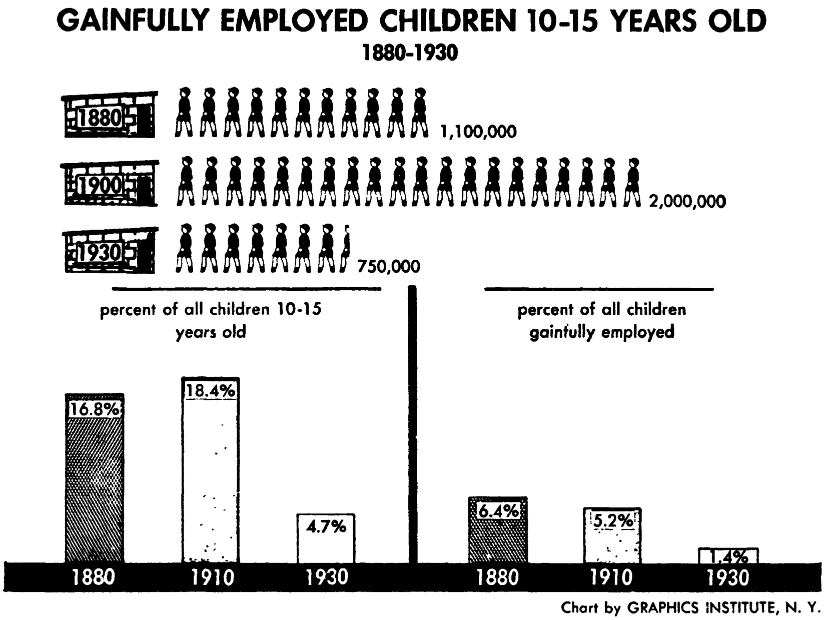
Women have begun to raise themselves out of the status of substandard workers. It remains to be seen whether the gain will be extended and will be permanent.

### Children as Workers

One of the indexes of social progress during the past hundred years has been the reduction of child labor, as shown in the chart opposite. In the 30 years from 1900 to 1930 the number of children declined from two million to less than half that figure. In 1930, less than five percent of children from ten to fifteen years old were working for pay, compared to almost 70 percent in 1900. In 1930, children from ten to fifteen years of age were only about one percent of the labor force, compared to five percent in 1900.

These figures are not completely accurate, since there is a certain amount of illegal, unrecorded employment of children. There can be no doubt, however, about the great gain we have made in this country in taking children out of the labor market. Three-fourths of the child workers of this country are now found on the farms; in manufacturing and trade the numbers are insignificant.

The entire community is interested in the elimination of child labor. We know, from the many studies which have been made, that the health of children is harmed by labor. Furthermore, young workers do




From 1900 to 1930 there was a decrease in the number of children working for pay (upper graph). The percentage of all children from 10 to 15 years of age working for pay in 1930 was about one-fourth of what it was in 1910 (lower left). Approximately the same drop took place in the percent of children of all ages gainfully employed (lower right). (Data from Census Bureau)

not get enough education and therefore have little opportunity to lift themselves beyond unskilled and semiskilled jobs, or what are called "blind-alley jobs," which offer little opportunity for advancement.

Over the past half-century every state has adopted some laws restricting the use of child labor. The chief method is a compulsory school-attendance law, which usually requires attendance until the age of sixteen; with some kinds of part-time work permitted at the age of fourteen. Many states forbid factory work for children under sixteen; they also limit the number of working hours per day and per week, and prohibit night work. The federal and state minimum-wage laws have also discouraged the use of child labor.

### Immigrants

A writer once said, "Immigration is the life history of this nation." The thirteen American colonies were, of course, founded by immigrants. During the hundred years from the end of the War of 1812 to the end of World War I, immigrants played an important part in the

growth of the United States into the greatest industrial and commercial nation of the world. Over 30 million immigrants came to this country during that period, 85 percent of them from Europe. Those who were themselves immigrants, or the children of immigrants, wanted to protect their newly-found prosperity against the competition of cheap-labor immigrants. This economic fear was coupled with religious and nationalistic prejudices.

From 1882 to the 1920's a series of laws were passed, setting up restrictions on immigration. The result is that, as far as immigration into the United States is concerned, the world is divided into three parts. The area of unrestricted immigration includes Canada and Latin America; there is no numerical limit on immigration from these countries. The no-immigration area includes Asia and the Pacific (except American-owned islands). No immigrants are allowed from this part of the world, except for a small Chinese quota. The *quota* areas include the countries of Europe, Africa, and the Near East, and China, Australia, and New Zealand. These quotas, or specified amounts, were set to allow about 125,000 immigrants a year from the countries of Northern and Western Europe, about 25,000 from the countries of Southern and Eastern Europe, and 105 from China.

World War II forced the easing of these restrictions. The world was moved by the tragic plight of the "D.P.'s," the millions of displaced persons, who had been uprooted from their homes in central and eastern Europe. Many groups in this country urged that our gates be opened to the D.P.'s; but there was general objection to abandonment of the immigration policies adopted in the 1920's. As a compromise, legislation was adopted to admit several hundred thousand D.P.'s, over and above the immigration quotas.

### Racial, Religious, and Nationality Groups

The manpower shortage of World War II did much to lower the bars of discrimination against minority groups. Employers overcame some of their prejudices and fears about hiring Negroes, and workers became accustomed to having Negroes as fellow workers. Many unions took steps to eliminate barriers against Negroes. One of the most important factors in the situation was the creation by President Roosevelt of the Fair Employment Practices Committee (FEPC). This committee was given the task of eliminating discrimination in employment. Its chief weapons were persuasion and publicity.

Wartime experience has shown that success in eliminating discrimination against minority groups in employment depends mainly on two factors: (1) the maintenance of full employment, so that competition for jobs is lessened, and (2) the extent to which governments and in-

dividuals are prepared to enforce equality of opportunity for employment.

The FEPC was forced to go out of existence in 1946, because of the opposition of the South. As of the beginning of 1950, however, eight states—Connecticut, Massachusetts, New Jersey, New Mexico, New York, Oregon, Rhode Island, and Washington—had laws forbidding business firms to discriminate against racial, religious, or national groups in the hiring of employees. Eight other states forbade such discrimination by contractors doing public construction work.

### The Fair Labor Standards Act

We have seen that much has been done to raise the levels of substandard groups by unions and by legislation. Most of the laws have been state laws. In 1938, the federal government passed the Fair Labor Standards Act, known also as the Wages and Hours Act. This law applies to all workers engaged in interstate commerce or in the production of goods for interstate commerce, unless they are specifically exempt, as in some agricultural jobs. The law provided for the gradual establishment of a minimum wage rate of 40 cents an hour; this minimum was raised to 75 cents in 1949. The maximum hours permitted are 40 hours a week; work beyond this amount must be paid for at overtime rates. The law also prohibits the employment of children under 16 years, with certain exceptions.

In addition, the Walsh-Healey Public Contracts Act (1936) provides that government contracts for the purchase of materials, or for performance of services, must include specified requirements as to wages, hours, child labor, and working conditions. These contracts have set up requirements which are in some cases well above the provisions of the Fair Labor Standards Act.

## Exercises and Activities

### I Dictionary of Economic Terms

immigration quota    substandard worker

### II Questions and Problems

1) State two reasons why substandard workers create a serious problem.
2) List four factors causing substandard working conditions.
3) Name at least four major groups of substandard workers.
4) Summarize the major provisions of the Fair Labor Standards Act in regard to (a) hours, (b) wages, and (c) child labor.

5) Do you believe in the principle of "equal pay for equal work," regardless of sex, race, religion or nationality? Give reasons for your answer.
6) Argue for or against the following propositions: (a) Since women get the benefit of special protective legislation, they are not entitled to equal pay. (b) There should be a uniform federal law regulating child labor throughout the country.
7) Federal inspections of manufacturing industries have revealed that a number of employers violate the Fair Labor Standards Act. What suggestions can you make for securing better compliance with the law?

III THINGS TO DO

1) Write an essay on the problem of migratory workers. A good fictional account is John Steinbeck's *Grapes of Wrath* (Viking). A comprehensive study of this problem and related problems is found in Carey McWilliams' *Factories in the Fields* (Little, Brown). What steps have been taken to deal with the problem?
2) Look up statistics on regional differences in earnings and write a report on your findings.
3) Write a report on the attempts of the National Farm Labor Union to raise the standards of farm workers.
4) Summarize the history of our immigration laws.
5) Plan a forum discussion or a debate on the question: Should the immigration bars be lifted for displaced persons?
6) Write a report on the child labor provisions of the Fair Labor Standards Act. Find out the regulations covering (a) different types of jobs, (b) part-time work while schools are in session, (c) vacation work.
7) Look up the laws of your state on any of the problems covered in this lesson.
8) Read and report on *Why Women Work* (Public Affairs Pamphlet No. 17, 1938).
9) Write to one of the state governments mentioned on page 463 for literature describing their antidiscrimination laws.

## *LESSON* 60 PROBLEMS OF INSECURITY

### TYPES OF INSECURITY

A well-paying job under good working conditions is an economic goal of workers. However, each has an additional goal, that of keeping his income and his economic status. There are many factors which tend to make income and economic welfare uncertain, which threaten the

worker with loss of income and reduction of standard of living. Along with his attempts to improve his present status is his striving to assure future well-being. This is the quest for economic security.

One type of insecurity which threatens constantly is that of ill health or disability, which may strike the wage earner or any person dependent upon his support. Sickness or accident to the breadwinner may have the effect of cutting earning power. The sickness of any member of the family imposes a burden of expenses for medical services and supplies that may drain the resources of all. Often the financial problems associated with illness or accident are more grievous than the medical problems.

A second type of insecurity is that which results from advancing age. Especially in the case of manual workers, it brings the threat of not being able to get or to hold a job. Many firms have established an age limit for new employees; the same is true in public employment. Frequently age is accompanied by increasing absenteeism and loss of income as infirmity and illness become more common. Coupled with the greater difficulty of earning a living is the greater expense required for medical attention and supplies.

A third type of insecurity results from uncertainty as to when death will strike the wage earner. Every person would like the assurance that upon his death, those he leaves behind will not be destitute. That this goal to provide security for loved ones is a common goal is evidenced by the widespread holding of life insurance policies.

A fourth type of insecurity results from the constant threat of losing one's job and source of income, the threat of *unemployment*. The chart on page 466 gives a view of the major causes of unemployment. Those who are too sick or too old to want employment or to be able to work are not, in a strict sense, to be included among the unemployed. Unemployment refers to the number willing and able to work who cannot secure jobs. Some unemployment results from personal factors; investigations have revealed that inability to adjust oneself to the job or to working with other people is a very frequent cause of unemployment. One of the chief tasks of education in school and the home is to teach individuals the skills and habits which make it possible for them to get and hold jobs. However, there are always some people who are looking for a new position, some who are changing from one occupation to another. This kind of unemployment, resulting from personal factors and possibly in accordance with the wishes of the individuals involved, is not a major factor contributing to insecurity.

Unemployment which results from changes in the number of jobs available, because of changes in business conditions, is a serious and constant threat to security. Business conditions tend to alternate be-

tween periods of prosperity and periods of poor sales and production called "depressions." This alternation of good times and bad times is referred to as the *business cycle,* or *cyclical fluctuation.* The unemployment which occurs when depression causes a shrinkage in the demand for labor is called *cyclical unemployment.* In 1929, when there were about 49 million people in the civilian labor force, there were about 2 million unemployed, approximately 4 percent. In 1932, a depression

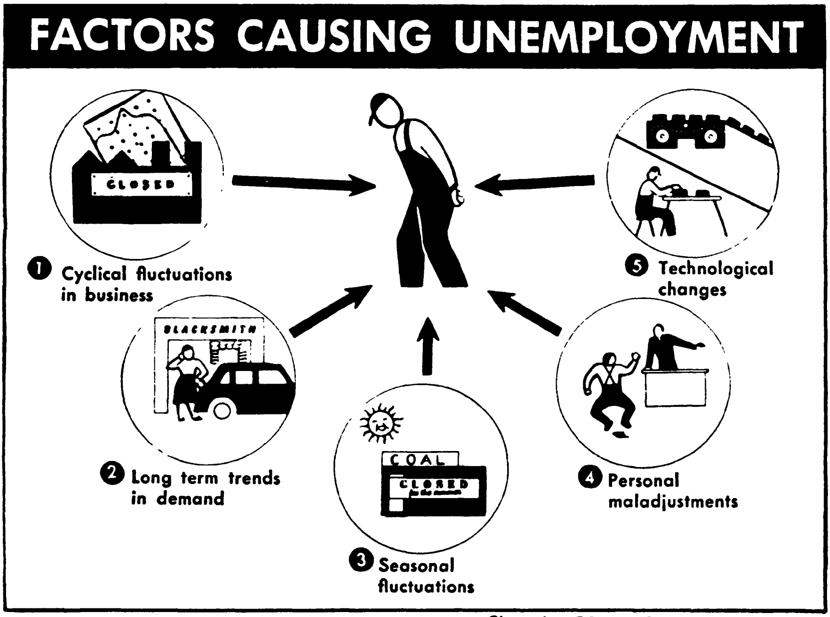



Chart by GRAPHICS INSTITUTE, N. Y.

All these factors operate at the same time. Which of these are particularly evident today?

year, there were about 13 million unemployed, in a total labor force of 51 million—more than 25 percent. It was a time of bread lines, of wage cuts, of relief measures, of economic suffering—a period of great insecurity. Cyclical unemployment is the consequence of inability to keep our productive machinery on an even keel. It is a source of insecurity that is not the fault of its victims. Society and industry may meet the problem in two ways: first, they may seek to eliminate or to reduce the cyclical fluctuations in business; second, they may strive to reduce suffering by providing some income for the unemployed.

In some industries the volume of business varies sharply from one part of the year to another; such are seasonal businesses. Examples are resort industries, fuel oil, coal, clothing. Unemployment which results from layoffs during the slack period each year is referred to as *seasonal*

*unemployment.* It is not so great an element of insecurity as cyclical unemployment because the slowing down of demand for labor is regular and is generally anticipated. In seasonal trade, particularly in industries in which there are strong unions, wage rates are higher during the busy season because the demand for labor is greater. Some unions provide for payments to their members during the slow season. Industry has tried with some success to iron out the unevenness in production during the year by using plant and equipment to make other products. Thus, a knitting mill may make bathing suits at one time and winter sweaters at another. One advantage of such measures to employers is the reduction of cost per unit by spreading overhead or fixed costs over a larger volume.

Long-term, gradual changes are referred to as *secular changes.* A secular change in style or consumption habits may produce gradual changes in demand for labor, resulting in unemployment. Thus, for example, a tendency for men to go hatless would affect the demand for workers having specialized hat-making skills. Long-run changes provide an element of insecurity to the individual. However, because of their gradual nature, there is time for the worker to acquire new skills and to enter a new occupation. Nevertheless, because it involves retraining, worry, and often reduced earnings, such long-term changes are an element of insecurity to the individual skilled worker.

*Technological unemployment* may result from the introduction of any labor-saving device, system, or invention. It is most dramatically evident when a machine is invented to replace hand labor. Thus the invention of a machine to make glass bottles almost eliminated the demand for glass blowing as a skilled craft. However, the glass-bottling machine lowered the cost of bottles. It became possible to produce them so cheaply that many more bottled products could be sold. The demand for labor in canneries, bottling works, retail stores, printing plants, steel plants, and others increased. In addition, the demand for labor in industries related to the manufacture of the machines themselves grew. Thus, to the individual worker, in the short run, technological change is an important element of insecurity. But, from the point of view of the total demand for labor, the invention and use of machines and efficient methods of production may not have caused an increase in total unemployment. However, statistical studies have not yet provided definite conclusions about the long-run effect of technology on unemployment.

### Private Measures for Increasing Security

There are measures which the individual can take to gain a degree of economic security. In the first place, he can often follow a program of saving which enables him to have financial resources to meet the

needs of sudden illness, disability, or death in the family. In the second place, he may be able to guard against illness and accident by regular consultation of doctors and dentists, and by following a sane and healthful manner of living. In the third place, he may buy insurance policies offered in bewildering variety by private insurance companies; he may buy accident insurance, health insurance, hospitalization, life insurance. He may provide for an income in his old age by the purchase of annuities from insurance companies.

The ability of the individual to provide his own security is, however, limited by his income. Most families cannot afford to pay the high costs of private insurance to the extent necessary to provide full security. Many cannot afford even a small life-insurance policy. It is well known that in many low-income families, funds are not sufficient to provide a fully adequate healthful diet, good living quarters, and fresh air, or to pay for the medical attention which is necessary to guard and preserve health.

What the individual may not be able to accomplish by himself may be easier through coöperative organizations. Thus lodges, burial societies, and beneficial organizations of varied kinds have developed. The member pays his dues regularly and is entitled to varying types of benefit, usually burial expenses and a small death benefit to survivors. Labor unions often provide similar benefits to members. Unions frequently pay benefits to members who are laid off during the slow season and have arranged for systems of pensions or annuities contributed to by members on a voluntary basis. Some unions operate their own insurance companies. Credit unions, often operated under union auspices, provide cheap credit to help meet emergency needs arising out of illness or unemployment. The last few years have seen growth in union demands for pension and welfare systems financed largely or wholly by the employers to supplement Social Security pensions.

Industry has taken some measures to provide greater security to employees. They have found that such measures make for happier, more efficient workers and that the costs have been repaid by increased productivity and decrease in labor turnover. Insurance policies paid for by the employer are sometimes part of the terms of employment. Some large firms employing thousands have established pension systems. Many firms continue to pay salaries to workers who are absent during periods of illness. Measures taken by employers to stabilize their business operations, thus reducing the possibilities of cyclical and seasonal unemployment, are indirect contributions to increased security for workers.

Private philanthropic organizations help to increase security. Organizations such as the National Foundation for the Prevention of Infantile

Paralysis and others have virtually become American institutions. They make their research and medical benefits available to all who are stricken. Nonprofit groups have been organized to provide hospitalization and medical benefits on a private-insurance basis. In some centers, groups of doctors have combined to offer medical services on an annual contract basis. Church organizations continue to provide many financial and medical services to those in special need.

### Government Measures for Increasing Security

Government measures related to increasing security have been numerous. One outstanding example is the operation of the workmen's compensation systems in most of the states, providing financial damages and payments for injury on the job. Measures taken to enforce good working conditions, safety regulations, and health standards are important, though indirect, methods of increasing security by preventing illness and injury. Local and state welfare services by the states and local governments, such as financial assistance to the needy, free hospital and medical services, pensions to widows, care for orphans, and institutions for the blind and crippled, have become more extensive.

More and more it has come to be recognized that the community at large may accept the responsibility for providing some degree of economic security. The individual worker is most often not responsible for the unemployment that blasts his standard of living. The industrial revolution made the wage-paying job the only means of support for most people. The day of family self-sufficiency on the farm, the day of the very large family living together on the family homestead, has changed, for most people, to city life, based on working for an employer. Out of this change arises the responsibility of all of us, every worker, employer, and the government, to provide for a minimum degree of economic security. Hence, the problem of economic security has come to be a problem of *social security*.

### Social Security

Social responsibility for certain elements of economic security was recognized in the Social Security Act of 1935. The act provided for three general measures to increase economic security. These were (1) a system of financial assistance by the federal government to the states to provide assistance to the needy, the disabled, and the blind; (2) a system of pensions for those over the age of sixty-five; and (3) a system of unemployment insurance benefits for those unable to secure work. The old-age pensions and unemployment-insurance parts of the legislation provide for *social insurance*. Social insurance is a system by which contributions by individuals or businesses from income or wages,

collected by a government agency, support the payment of benefits to eligible persons at a specified time, or subject to specified conditions. It is similar to private insurance except for the fact that it is administered by the government and is compulsory.

Federal old-age pensions are supported by contributions by employees and by employers. Employees pay a stated percent of wages, and employers pay a stated percent of their total payroll. Upon reaching the age specified, for example, sixty-five years according to the current law, the wage earner, his wife, or his survivors are entitled to specified death benefits or monthly benefits, depending upon the sums contributed to the social-security fund or reserves. The next lesson will set forth the provisions of the federal social-security system in more detail.

The provisions for unemployment insurance set forth minimum standards which the states must maintain if they wish to receive contributions from the federal-reserve funds. These unemployment insurance reserves are paid entirely by employers who must pay a stated percent of their total payroll. Thus the employee finds his wage reduced only by his contribution for old-age pensions; the employer contributes to the payment of both old-age pensions and unemployment insurance for his workers. Subject to the provisions of the state laws, workers who lose their jobs receive weekly unemployment payments for a definite number of weeks. In some of the states, a *merit-rating system* of levying unemployment-insurance taxes has been devised, whereby employers with a good record of maintaining employment pay lower rates than those with high turnover rates.

Public assistance under the Social Security Act does not involve a new principle. For many decades, state and local governments have provided help to needy people—the aged, orphans, physically handicapped, and others unable to support themselves. The *public-assistance program* of the federal government is, therefore, a means for helping the states to expand their aid to the needy.

Under the Social Security Act, the federal and state governments share in paying for public assistance and in seeing that it is properly administered. The federal government sets a general pattern and pays to each state about half of what the state spends for public assistance. Thus, the more the state spends for public assistance, the more the state gets from the federal government, up to a specified limit.

Public assistance has several phases. One is help to old people who get no old-age insurance benefits, or whose benefits are insufficient to maintain a minimum standard of living. Aid is also given to orphaned children up to the age of sixteen, or to eighteen if the children are attending school. Federal aid is provided, likewise, for special health and welfare programs.

Recent years have seen the introduction of proposals to extend the social-security activities of the federal government in two directions. It is proposed, first of all, to extend the provisions of the act to workers now not covered and to enlarge the benefits. Second, it is proposed to introduce *health insurance.* Health insurance, under government auspices, provides for a system of charging workers and employers a percent of wages, (1) to pay workers part of the wages they may lose on account of sickness, and (2) to pay their medical and hospitaliza-

**HOW THE SOCIAL SECURITY SYSTEM FUNCTIONS**

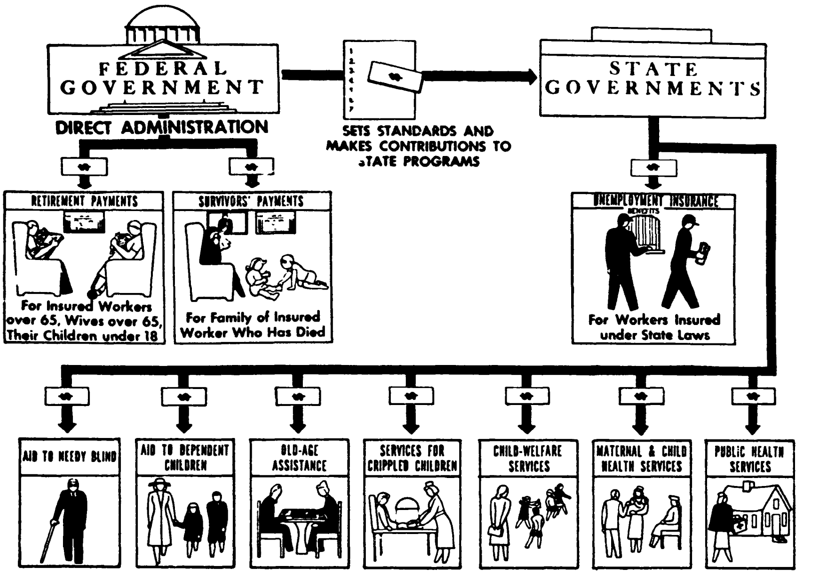



CHART BY GRAPHICS INSTITUTE, N.Y.C.

The diagram shows the dual nature of our social security system. The federal government directly supervises the old-age retirement pensions of workers over 65 and payments to survivors. It sets standards and provides financial assistance to states for unemployment insurance and aid to the needy.

tion expenses. Under this plan, workers would be privileged to receive free medical attention from groups of doctors receiving payment from the government. This plan has been advocated in order to cut down medical costs and to ensure the availability of medical services to lower-income groups. It has been assailed as being socialistic, as turning doctors into overburdened government employees, and as destroying the personal relationship between doctor and patient.

In the meantime, in response to the suggestion that health and medical insurance be put on the basis of social insurance, many private and voluntary schemes have been advocated. Recently a few states have adopted a system of *disability insurance,* which is a partial system of

health insurance. It covers the first of the two features mentioned above, namely, payment for work time lost on account of sickness.

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| cyclical unemployment | seasonal unemployment |
| disability insurance | secular changes |
| health insurance | social insurance |
| merit-rating system | technological unemployment |
| public assistance program | unemployment |

### II Questions and Problems

1) (a) Describe the four major types of economic insecurity. (b) What are major remedies for each of the four types?
2) Show how the following factors have affected the problem of insecurity: (a) city life, (b) the nature of modern industry, (c) the increase in life expectancy.
3) Give an example of each of four types of unemployment.
4) Choosing a specific technological improvement, show how it may result in both displacement and reabsorption of workers.
5) For two hundred years workers have feared the machine. Why? To what extent have their fears been justified?
6) Some economists and businessmen say that a certain amount of unemployment is desirable, because it provides flexibility in the economy. (a) What do they mean? (b) What is your opinion?
7) (a) What are the three types of social security provided in the Social Security Act? (b) How does social insurance differ from the public assistance part of social security? (c) Why can we not rely on private insurance alone to take care of economic insecurity?
8) Social insurance makes labor an overhead cost to the community. Explain.
9) "The key to real social security is full employment." "Progress requires insecurity." Discuss these opposing statements.

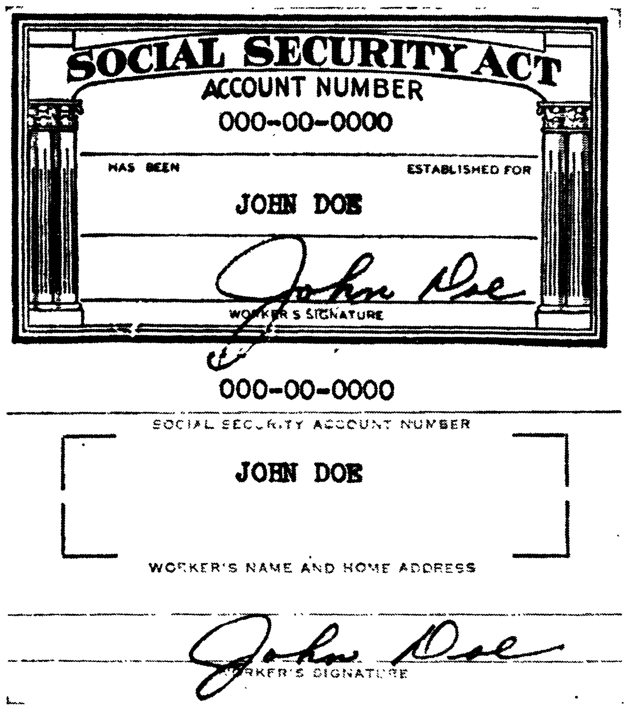
### III Things To Do

1) On the basis of library research, report on plans which have been adopted by some business firms for reducing seasonal unemployment.
2) Plan a forum discussion or a debate on one or both of these subjects: (a) An employer should not be permitted to introduce labor-saving devices unless he provides for the displaced workers in one way or another. (b) The United States should adopt a program of health insurance.

# LESSON 61 SOCIAL SECURITY

### What Is a Social-Security Card?

This is what a social-security card looks like.




When you get your first job in any firm or industry whose workers are covered by social-security legislation, you must obtain a social-security card. You may apply directly at the local office of the Social Security Administration, which is part of the Federal Security Agency. You may also apply and receive your card by mail. Application forms may be available in your school. They are available at your local post office if your residence is far from a social-security office.

### What Is a Social-Security Number?

A social-security number is stamped in red on the face of your social-security card. Your social-security card certifies that an account bearing that number has been opened in your name. In 1949 there were over 90 million accounts on file. The number is simply a convenient device for

identifying an account and for making certain that benefits are paid to the right person.

When you receive your social-security card, you will note that the number is duplicated on a bottom stub, which you are urged to file in a safe place. If you lose your card, you can immediately secure a duplicate by presenting this bottom stub to the social-security office. If you lose the stub, too, you may get a duplicate by making out another application and including on it your original number. Some people foolishly apply for a second card with a new number. There will be no loss if, when retirement age or death arrives, the clerks in the social-security office can combine the two accounts and be sure that they belong to the same person. However, should they fail to do so, the benefits received will be smaller, because they are based on the entries on only one of the two accounts held in the same name. It is important for every worker to keep a record of his social-security number. It is also important, to avoid confusion in later years, to fill out the application fully. Thus, if the worker's name is one like John Smith, it is exceedingly important that he fill in his middle name, if any, and include all other identifying data, such as his mother's maiden name.

### What Is a Social-Security Account?

The account which bears your number is simply a record of all the amounts paid by you and your employers for your benefit. Every three months your employer sends a report to the Social Security Administration, listing your name and number and indicating the amount of wages paid to you. He is also responsible for sending to the proper government office the amounts which have been deducted from your wages, as well as his own contribution.

### What Benefits Are Provided?

There are several types of benefits. First, a worker who retires at the age of sixty-five is entitled to receive a monthly *old-age pension*, the amount of which depends largely upon the amount and period of contributions made to his account. Second, if a worker dies before reaching the retirement age of sixty-five, his wife and children may be entitled to *survivors' benefits.*

### What Are Old-Age Pensions?

These are monthly payments made by the federal government to workers in industries covered by the law who have had sufficient contributions paid into their accounts for a long enough period of time prior to retirement. They are payable after the age of sixty-five is

reached, provided the worker has retired from work. If he continues to work, the payment of old-age pension benefits is suspended until he retires. The old-age pension to a retired worker is supplemented by a pension to his wife when she reaches the age of sixty-five. If there are children under eighteen years of age, an additional payment for each such child is made until he reaches the age of eighteen. When a retired worker dies after reaching the age of sixty-five, his wife, if she is over sixty-five, continues to receive a monthly pension, which, however, is not as large as that received originally by her deceased husband.

### How Large Are the Monthly Pensions?

The minimum pension is $10 per month, the maximum is $85; however, the average payment has been something under $30. The amount depends upon the wages received. One reason for the low average payment is that the law has been in effect a relatively short time, so that contributions have not accumulated for a long period. Furthermore, the low level of wages prior to the war years made contributions low because they are figured as a percent of wages.

If the husband receives $40 per month at the age of 65, his wife is entitled to an additional payment of 50 percent, or $20, when she reaches the age of 65. The same is true for each child under 18. Thus a retired worker whose wife has reached 65 and who has one child under 18 and who receives $40 as a monthly pension, will find it supplemented by $20 more for his wife and $20 for the child—an additional amount of $40 a month. Upon the worker's death, the wife is entitled to receive a pension of three-fourths of her husband's pension, or, in the example given, a monthly payment of $30.

### If a Worker Dies Before He Is Sixty-Five, Is There No Benefit at All to His Family?

Even though he was a contributor, there is no old-age pension if a worker dies before he is sixty-five. However, there are survivors' benefits. The surviving widow and children under eighteen are entitled to receive a lump sum payment or a monthly benefit. The amount and duration of the payments vary with circumstances.

### Does the Government Notify Workers of Benefits Due?

The worker or his survivors must inquire about social-security benefits which may be due. Inquiry is simple. A letter, mentioning the worker's social-security number, will bring a response or the appropriate form from the social-security office. The location of the office can be learned by inquiring at the post office.

**May a Worker Over Sixty-Five Continue to Work and Still Receive Benefits?**

The answer to this question is both yes and no. A worker may receive benefits while working in an occupation not covered by social-security legislation. Thus, a person over sixty-five who has previously worked in industry and is receiving benefits, may work for the government and receive a salary in addition to the benefits, as long as government workers are not covered by social-security legislation. However, in an industry covered by social-security legislation, a worker receiving a pension may not earn more than $14.99 per month. If he does, he is disqualified from receiving his pension.

**Which Industries or Jobs Are Not Included?**

Farm workers, domestic servants, seamen, railroad workers, student nurses or interns in hospitals, casual workers, and employees of federal, state, and local governments are not covered by social security. This means that they neither make contributions nor receive any benefits. Workers in firms employing fewer than four workers are also excluded from the provisions pertaining to old-age insurance.

**What Does the Worker Pay for Federal Old-Age Pensions?**

Since the social-security system started its operations in 1937, a deduction has been made from the wages of those workers who are included in the system. In 1950 the deduction was 1½ percent on all wages and salaries up to $3000 per year. A worker in 1950 who earned $40 per week or $2080 per year contributed 60 cents a week or $31.20 per year. If he was paid on a weekly basis, his pay envelope would contain $39.40 (assuming there was no income-tax deduction) instead of $40. A worker who earned $100 a week, or $5200 a year, would have $1.50 deducted each week for the first thirty weeks. Thereafter there would be no deduction until the year was over, since the deduction was based on the first $3000 of earnings only.

Workers who change their jobs in the middle of the year should note that the total deductions may amount to more than the maximum 1½ percent of $3000. Suppose a worker earning $100 a week works for 26 weeks starting on January 1 and has 26 times $1.50 deducted, a total of $39. He then changes his employer and earns $100 a week for the second half of the year. The new employer will also deduct 1½ percent on the $2600 paid in wages. Thus another $39 will be deducted, making a total of $78 during one year. The social-security administration will credit these payments to the worker's account, but when the time comes to figure his benefits, they will give him credit for only the maximum allowable, 1½ percent of $3000, a total of $45. Therefore he has over-

paid by the difference between \$78 and \$45 or \$33. This sum the worker can claim as a refund if he applies within two years. After two years he may make no claim. Millions of dollars are thus overpaid because of the failure of workers to check their payments and because of their ignorance of the fact that refunds are payable.

### Does the Worker Get Back as a Pension Only What He Pays In?

In the first place, the old-age-pension system is like an insurance system under federal operation. A worker who lives for many years after reaching the retirement age gets back considerably more in pensions than a worker who dies shortly after reaching retirement age. Many workers who choose to continue to work receive no old-age pensions at all. Some may be entitled to the minimum payment of \$10 per month, even though on the basis of contributions the pension would be less. Some receive only the maximum, even though on the basis of contributions the payment might be more.

In the second place, the worker's contribution is doubled because his employer is required to pay an equal amount as a payroll tax. The worker who pays 60 cents on a weekly wage of \$40 has \$1.20 added to his account because of the employer's contribution.

In the third place, the contributions paid, like the premiums paid to an insurance company, may be invested in government securities and thus increase the total reserve funds available to the social-security administration.

### What Are Unemployment Insurance Benefits?

These are weekly payments for a specified number of weeks during which the worker cannot find a job.

### How Is Unemployment Insurance Related to Old-Age Pensions?

Both old-age pensions and unemployment insurance were provided for by the same act. However, the Social Security Act of 1935, which set forth all the details of federal old-age pensions, simply provided for additional contributions by employers for unemployment benefits and provided that the state might determine, subject to minimum federal standards, what the details of unemployment insurance were to be. There is one important relationship, as far as the worker is concerned, between the old-age pension and unemployment insurance. Just as his old-age pension is determined by the amount and duration of contributions shown in his social-security account, so the benefit he may receive for unemployment also depends upon his earnings and the duration of his previous employment, as shown in the social-security records.

### How Large Are Weekly Unemployment Payments and for How Long Are They Paid?

Since unemployment benefits are determined by state law, they vary from state to state. Furthermore, the actual payment varies from individual to individual within a state, in accordance with the earnings and duration of employment before the loss of a job. The table below shows the maximum weekly payments and maximum duration of payment in the forty-eight states as of August, 1949.

State Unemployment Insurance Benefits

| *State* | *Maximum Weekly Benefit* | *Duration (in Weeks)* | *State* | *Maximum Weekly Benefit* | *Duration (in Weeks)* |
|---|---|---|---|---|---|
| Alabama | $20 | 20 | Montana | $20 | 18 |
| Alaska | 25 | 25 | Nebraska | 20 | 20 |
| Arizona | 20 | 12 | Nevada | 25 | 26 |
| Arkansas | 22 | 16 | New Hampshire | 25 | 23 |
| California | 25 | 26 | New Jersey | 22 | 26 |
| Colorado | 22.75 | 20 | New Mexico | 20 | 20 |
| Connecticut | 24 | 26 | New York | 26 | 26 |
| Delaware | 25 | 26 | North Carolina | 25 | 20 |
| District of Columbia | 20 | 20 | North Dakota | 20 | 20 |
| Florida | 15 | 16 | Ohio | 25 | 26 |
| Georgia | 18 | 16 | Oklahoma | 22 | 22 |
| Hawaii | 25 | 20 | Oregon | 25 | 26 |
| Idaho | 20 | 20 | Pennsylvania | 25 | 24 |
| Illinois | 20 | 26 | Rhode Island | 25 | 26 |
| Indiana | 20 | 20 | South Carolina | 20 | 18 |
| Iowa | 22.50 | 20 | South Dakota | 20 | 20 |
| Kansas | 25 | 20 | Tennessee | 20 | 20 |
| Kentucky | 20 | 22 | Texas | 20 | 24 |
| Louisiana | 25 | 20 | Utah | 25 | 20 |
| Maine | 25 | 20 | Vermont | 25 | 20 |
| Maryland | 25 | 26 | Virginia | 20 | 16 |
| Massachusetts | 25 | 23 | Washington | 25 | 26 |
| Michigan | 24 | 20 | West Virginia | 25 | 23 |
| Minnesota | 25 | 25 | Wisconsin | 26 | 34 |
| Mississippi | 20 | 16 | Wyoming | 25 | 20 |
| Missouri | 20 | 20 | | | |

Note: Some states give extra benefits for dependents.

A worker seeking benefits must register at the local office of the state unemployment office. Thus at the same time he applies for benefits he applies for employment. Generally the state laws base the amount of the payment on the earnings during a base period, perhaps the year

ending six months prior to filing the claim. There is a *waiting period* of one or more weeks, during which the worker receives nothing; thereafter he receives unemployment checks equal to a percent of his weekly earnings during the base period, but in no case more than the maximum allowed by state law.

### Does the Applicant Have To Take Any Job Offered?

When applying for unemployment insurance, the worker must register for a "suitable job." This is one which fits his physical ability, education, previous work experience, and the wages he has been accustomed to earn, and which also is reasonably near his home. If a suitable job is refused, the worker may be disqualified from receiving further benefits. The unemployment office decides each case on its merits.

### Under What Other Circumstances May a Claimant Be Disqualified?

Some of the reasons for disqualification for unemployment insurance in some states are the following:

(1) The claimant is ill, aged, or disabled to the point of not being able to perform any marketable services.

(2) The claimant is unwilling to accept a suitable job.

(3) The claimant was discharged for misconduct, refusal to obey orders, intoxication while working, or absenteeism.

(4) The claimant is a striker. Two states do permit benefits to strikers but after a longer waiting period. It has, however, been ruled that a worker who refuses a job which exists because there is a strike or lockout may not be disqualified as refusing a suitable job.

(5) The claimant quit work to get married, to attend school, or to take a vacation.

(6) The worker received pay from his employer covering the period of unemployment.

### Who Pays for Unemployment Insurance?

In most states only the employers pay a 3-percent tax on their payrolls. In two states employers pay a 1½-percent payroll tax, and workers pay a 1½-percent tax on their wages. Many states have introduced a *merit rating* scheme, which provides that employers whose record of maintaining employment is good are allowed to pay a smaller tax for unemployment insurance.

### What Have Been Some of the Suggestions for Extending Social Security?

Those who have criticized social-security legislation on the grounds that it does not go far enough have pointed to the smallness of the pen-

sion payments, the fact that many workers are not covered, and the absence of health and medical insurance as its chief weaknesses. They suggest

(1) That pension maximums be raised

(2) That retired workers be entitled to earn more than $15 per month and still qualify for old-age pensions

(3) That wives of retired workers get pensions at 60 instead of 65

(4) That social security taxes be levied on a sum greater than the present maximum of $3000 to permit larger benefits

(5) That workers in uncovered occupations be included

(6) That unemployment benefits be based on the number in the family of the unemployed worker as well as on the amount of his previous earnings

(7) That larger sums be appropriated from general tax funds to permit more generous welfare allowances by the states

(8) That a health insurance system be established

## Exercises and Activities

### I Dictionary of Economic Terms

old-age pension
social-security account
waiting period
survivors' benefits
unemployment-insurance benefits

### II Questions and Problems

1) Summarize the social security benefits which are available in each of the following cases: (a) A worker retires after reaching 65. (b) A worker dies, leaving a wife and two children. (c) A worker is laid off. (d) A person is physically handicapped and thus unable to support himself.
2) Argue for or against the following proposals: (a) to begin old-age pensions at the age of 60, (b) to cover all persons, regardless of occupation, (c) to pay all persons an equal pension, (d) to abolish the waiting period in unemployment insurance, (e) to tax workers for unemployment insurance, (f) to base unemployment-insurance benefits on the number of people in the family.
3) Why is unemployment insurance generally regarded as preferable to home relief (dole)?
4) Why is our unemployment insurance called a federal-state system?
5) List the features of our social-insurance system that you approve of and any that you disapprove of. Defend your listing.

### III Things To Do

1) Report on the history of social insurance.
2) Compare our social insurance system with that of some other country.

3) Arrange for a representative from your local social-security office to speak to your class on social-security problems.
4) Find out where in your community information is available about social security. Obtain in person, or by writing, pamphlets describing the social-security system.

*UNIT* 11

# LABOR-MANAGEMENT RELATIONS


62 THE PRINCIPLES OF COLLECTIVE BARGAINING

63 THE STRUCTURE OF UNIONS

64 UNION ACTIVITIES

65 PEACEFUL SETTLEMENT OF LABOR DISPUTES

66 LABOR-MANAGEMENT CONFLICT: UNION METHODS

67 LABOR-MANAGEMENT CONFLICT: MANAGEMENT METHODS

68 REGULATION OF COLLECTIVE BARGAINING

69 DEVELOPMENT OF THE AMERICAN LABOR MOVEMENT

# LESSON 62 THE PRINCIPLES OF COLLECTIVE BARGAINING

### Individual Bargaining

Joe Doakes has all kinds of complaints about his job. He hasn't had a wage increase for a long time, and his family expenses have been going up. He is all the more disturbed because Sam Barnes, who started on the job after Joe, has received several promotions as well as wage increases. Joe feels that this is the result of favoritism in the plant. And the hazards of the job are worrying him, too. Only last week one of the men got his arm caught in his machine.

There is no union in this factory; every man stands alone. So Joe Doakes gets his courage up and asks his foreman if he can have a word with him. "Christmas is coming," he begins. . . .

From here on the story has a hundred-and-one variations. One foreman will say, "If you don't like this job, you can look for another," and that's that. Another will invite Joe into his office and have an honest, give-and-take chat with him. How much satisfaction and consideration Joe will get will depend only partly on the justice of his requests; much will depend upon the generosity and personality of his supervisors, and on how badly they need him on the job.

In modern industry, the individual worker is a cog in a vast industrial machine, and usually, each one is a relatively unimportant cog, an "expendable" one. To overcome the handicap of individual bargaining, the workers band together. They form *labor unions.*

### The Formation of Labor Unions

The labor union, in the real sense of the term, is only a few hundred years old, a creature of modern times; and strong labor unions are a much more recent development. It is true that as far back as ancient times workers organized and engaged in strikes and revolts. But these were temporary, short-lived affairs. A labor union is a continuous organization of workers for the purpose of representation in dealing with employers. Before workers could organize on any permanent basis, two economic conditions were needed. First, there had to be a class of free workers who worked for wages. In olden times, organization among slaves or serfs, who were the property of their masters or lords, was considered insurrection. Second, the free workers had to recognize that they would probably remain workers (or wage earners) for the rest of

their lives. This was unlike the situation of the medieval apprentice, who expected to become an independent businessman, a master, through the normal operation of the guild system. Today most workers realize that they must try to improve their condition as workers, since most of them will continue to be workers throughout their lives.

There have also been a number of social factors that have encouraged and induced modern workers to join labor organizations.

*ILGWU, photo by Harry Rubenstein*

**A conference of representatives of the International Ladies Garment Workers' Union (AFL) and employers to determine the piece rate for manufacturing a specific garment.**

One is the great advance in education. The ideas of unionism can be transmitted much more readily among workers who read and write. Another factor has been the growth of democracy, which gave workers the feeling that they had a right to equality of bargaining power with their employers.

Nor should the individual psychological factor be neglected. A union gives people an opportunity to get together, just like any other form of club or organization. The union provides opportunities for self-expression. If a worker has ability and ambition, he can become a union officer and thus exercise whatever qualities of leadership he may have —skill in public speaking or in writing, executive ability, persuasive-

ness. As a rank-and-file member or as a leader, the union often gives a man a cause to work for, an activity that may add meaning and interest to his life.

### Advantages of Collective Bargaining

Now, as members of a union, when the workers want to discuss matters with their employer, they rarely meet him individually. Their *negotiation* is done collectively through the union. *Collective bargaining* is the attempt of union representatives and an employer to agree on the conditions of employment. It is "collective" as distinguished from "individual bargaining" because the workers act together through the union, and the union acts for a group of workers, not just for an individual worker. Sometimes employers also act together as a unit, through *employers' associations.*

Collective bargaining has many advantages for the worker over individual bargaining. When the union representative speaks to the employer on behalf of all the workers, the employer is less likely to say, "If they don't like this job, they can look for another." And if he does, there are many ways in which the workers can help one another. In this view, because they are united, the men are no longer competing with one another for jobs. The employer cannot play one man against another, with the knowledge that if one man doesn't accept his terms, another will. Nor is he able to tempt the superior workers with higher wages, and thus get them to be interested in themselves alone. The men are ready to demand and accept *standard* wages, hours, and working conditions—the minimum terms at which any worker may be employed.

If the employer refuses to grant their terms, the workers are in a position to refuse to work, that is, to *strike.* In so doing, they are merely exercising their legal right to withhold their labor. It is vastly different now, when the entire plant walks out together, from the time when Joe Doakes might have walked out alone.

If they should consider it necessary to go out on strike, the workers find that organization and advance planning have served them in good stead. The union has built up a strike fund out of the dues that the men have been paying. Now, while the men are out on strike, they may receive *strike benefits*—payments to the strikers by the union—which will, to some extent, serve as a substitute for wages. The workers thus have a money reserve, to match, more or less, the reserve that the employer generally has. If the employer can afford to keep his plant shut while waiting for the workers to accept his terms, the workers can now afford to stay idle while waiting for the employer to come to terms.

There is another aspect of this collective bargaining that Joe Doakes appreciates sooner or later. When he went in to speak to the boss, he found it difficult to cope with the greater experience and self-confidence

of his employer. As a group, however, the workers can now begin to match the employer in skill and knowledge at the bargaining conference.

The result of all this is that collective bargaining tends to equalize the bargaining power of the workers and the employer.

Labor unions have been criticized as being, by their very nature, labor monopolies, which artificially control the supply of labor. Such control makes possible unreasonable demands on employers, who in turn have to pass their higher costs on to the public. However, as will be seen in later lessons, legislation recognizes a distinction between a labor union and a business monopoly. This distinction is based primarily on the view that "The most important aims of the organized labor movement . . . are consistent with the objectives of a healthy economy. . . . By contrast, restrictive collusion by business groups is not directed toward desirable social goals."[1] There has, however, been condemnation of specific practices of some labor unions, as being monopolistic actions.

### Union Recognition

The first step in any collective bargaining is that the employer *recognizes the union.* This means that he accepts the union as the representative of the workers in negotiations. Until 1825 in England, and until 1842 in the United States, the mere legal right of workers to organize was not recognized in most courts of law. A labor organization was considered a conspiracy in restraint of trade; it was a criminal offense to combine, in order to raise wages or otherwise improve the conditions of work. When finally the law did recognize the right of workers to organize, unions had to battle their way for recognition by employers. It took many years of labor struggle before the major industries recognized labor unions. The Clayton Act of 1914 strengthened the right to organize unions. But not until the New Deal legislation of 1933 and 1935 compelled employers to bargain collectively with unions, could union recognition be taken for granted. Unionism and collective bargaining are now accepted institutions of American life.

Union recognition comes more readily when the workers in a plant or industry are highly organized. The degree of unionization varies greatly among American industries. Practically all the workers belong to their respective unions in the building industry, in coal mining, in garment making, in steel, in glass, and in transportation (rail, bus, trucking, and ocean shipping). At the other extreme, comparatively few are union-

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[1] Corwin D. Edwards, *Maintaining Competition,* McGraw-Hill Book Company, 1949, p. 78.

ized on the farms, in office work, and in trade (retail and wholesale). Many industries lie between these two extremes. Therefore millions of workers are still without the protection that comes with union recognition.

UNION SECURITY

When a union has only recently won a hard-fought battle for recognition, or when continued recognition by employers is uncertain, or sometimes for other reasons, the union may seek to adopt some device to protect its status as the representative of the workers. In other words, it seeks to establish *union security*.

The most familiar of these devices is the *closed shop*, in which the employer agrees to employ only members of the union. It enables the union to be sure of its control of the supply of labor, thus keeping out substandard competition by nonunion men. Another reason for this practice is the feeling among union members that since all the workers in a plant, union and nonunion, receive the benefits that the union wins, they should all help to foot the bill. Those who pay union dues resent the existence of "free riders" or "dues dodgers."

Employers generally have fought against the closed shop. They feel that it gives the union too much strength. They also resent the fact that it limits their choice of workers, which is a limitation upon their freedom of contract. Many people also feel that it is wrong to force a worker to belong to any particular organization in order to be able to work.

The closed shop becomes particularly objectionable to many people when it is coupled with a *closed-union* policy. In this case the union restricts very closely the right of workers to join the union. The union members are thus able to monopolize the supply of labor in their field.

In order to meet some of these objections, many unions have adopted a variation of the closed shop called the *union shop*. In this case the employer may hire anyone he chooses, but the worker must join the union within a specified period after his hiring. The Taft-Hartley Act forbids the use of the closed shop, but permits the use of the union shop under certain conditions.

There are several variants of the union shop. In the *preferential shop*, union men are given preference in hiring, and nonunion men are hired only if union men of the required ability are not available. During the war *maintenance of membership* provisions in union contracts became widespread. Most unions agreed not to call a strike during the war; in return, they sought a guarantee from the employers that all workers who were members of the union at the time of the agreement would maintain their membership in the union during the life of the agreement.

Some unions have required the use of the *union hiring hall* as a means of enforcing whatever form of union security they have. The employer agrees to hire all his workers through a hiring hall maintained by the union. In the maritime industries, particularly, before this device existed, it was very easy for employers to pick up migratory workers, hobos, and youngsters looking for adventure or temporary fill-in jobs. This practice disrupted wage standards and other standards set by the union. Management, however, objects to the hiring hall for the same reasons that it objects to the closed shop.

In opposition to all these forms of union security, many employers have sought to maintain an *open shop.* By definition this is a shop where any person may work, whether he is a member of a union or not. Labor unions contend, however, that the term "open shop" has usually been a catchword, to conceal the fact that the shop is really open only to nonunion workers and closed to union workers.[2]

To a large extent the public welfare is dependent upon union security. A secure union does not feel the need to keep fighting; it is able to coöperate with the employer, who can to a large extent rely upon the responsibility of the union to keep the workers in good order. As a veteran labor-news reporter puts it, one of the chief requisites for lasting labor peace is "the emergence of unions that are strong enough to be secure and secure enough to be responsible."[3]

## Exercises and Activities

### I Dictionary of Economic Terms

| | |
|---|---|
| closed shop | open shop |
| closed union | preferential shop |
| collective bargaining | standard conditions |
| employers' association | strike benefits |
| labor union | union hiring hall |
| maintenance of membership | union recognition |
| negotiation | union security |
| non-union shop | union shop |

### II Questions and Problems

1) "In modern industry, the individual worker is generally expendable." (a) Explain this statement. (b) Show how collective bargaining overcomes this handicap.

[2] Cf. Carroll R. Daugherty, *Labor Problems in American Industry,* Houghton Mifflin Company, for a detailed analysis of types of union security.

[3] A. H. Raskin, in *The New York Times,* Sunday Magazine, Dec. 12, 1948, p. 29.

2) Explain the reasons for the growth of labor unions.
3) If you were a worker with superior ability, would you be in favor of standard conditions for all workers in your plant? Explain.
4) (a) Describe the various types of union security. (b) How do workers justify the union shop and closed shop? (c) What criticisms have been made of the union shop and the closed shop?
5) As a substitute for the closed shop, it has been proposed that where a union obtains a union contract with an employer, all the workers should be required to pay union dues, without being compelled to join the union. What do you think of this proposed compromise?
6) What is meant by "labor monopoly"? Discuss this problem from the viewpoint of (a) labor, (b) management, (c) consumers.
7) It has been charged that collective bargaining has been developed to the point where labor is more powerful than management. Labor denies this charge. What is your opinion? Give reasons.

III THINGS TO DO

1) Read and report on *Your Stake in Collective Bargaining* (Public Affairs Pamphlet No. 117, 1946).
2) Read and report on *The Truth about Unions* by Leo Huberman (Pamphlet Press, 1946). Both explain the principles of collective bargaining, and contain materials useful for the following lessons.

# *LESSON* 63 THE STRUCTURE OF UNIONS

## JOINING A UNION

Perhaps you have already joined a union, while doing part-time or summer work. If not, there is a considerable chance that you will when you are older. One of every three American workers is a member of a labor union; in manufacturing, half of all workers are union members. Many firms have a closed-shop or a union-shop contract, and it is necessary to join the union in order to get or to keep the job. In other places there may be no compulsion to join, but you may find that many of your fellow workers are union members, and you will soon be asked by them to join the union.

Joining the union is usually an easy matter. In a well-organized plant, you will be approached by a union representative. The *jurisdiction* of a union is the craft, industry, or area in which it claims the right to organize the workers.

Some unions practice discrimination in membership. The groups barred from membership in such unions are usually Negroes, and some-

times aliens, or women. When such a union operates under a closed shop, the discrimination prevents these people from obtaining employment in the industry. This kind of discrimination has declined appreciably in recent years, under the influence of progressive labor leaders and as a result of antidiscrimination legislation in various states.

Some unions bar membership to communists, fascists, and other advocates of totalitarianism. A much larger number of unions merely prohibit such persons from being union officers.

Your first step in joining a union is to sign an application blank, in which you pledge yourself to obey the constitution and by-laws of the union. You pay the initiation fee, and you will probably soon be notified of your acceptance as a member. The initiation fee may be as low as $1, or as high as $20 or $25. In the building trades and in other skilled trades, the initiation fee sometimes amounts to hundreds of dollars. A high initiation fee is partly to restrict the labor supply and partly to make the new members pay for their share of the previous cost of building the union. Monthly dues vary according to the customary earnings of the workers in the union; in most unions the monthly payment is from $1 to $3 a month. If your union has arranged for a *checkoff*, your dues will be deducted by the employer from your pay and turned over to the union.

You may occasionally have to pay a special *assessment*, or tax. The purpose of the assessment may be to raise a strike fund, to contribute aid to the needy children of Europe, or to help in some other special project.

Once you have joined the union, you will probably want to attend union meetings, especially if your fellow workers are active members. In some unions you may be disappointed with the poor attendance at the meetings, for many members are as careless about their union responsibilities as people in general are about their civic responsibilities. In some unions attendance is good because the members are kept interested by active and capable leaders. A number of unions get good attendance by levying fines on members who are absent without a reasonable excuse. In any case, attending union meetings will enable you to learn who runs the union, what it does for you, how its funds are raised and spent, and what part the union plays in the life of the community. You should also receive a copy of the union constitution and literature describing the union's activities.

### The Local

Describing the structure and activities of labor unions is difficult because no two unions are exactly alike.

A *local* is the smallest formal unit of a union organization. The size

of a local and the type of workers it includes vary according to the industry and locality. In large-scale industries such as the automobile and steel industries, there may be a separate local for each plant. In a handicraft trade, such as carpentry, a local may include all the members of that craft in the city or in the county. Sometimes a local has a few dozen members, sometimes many thousands. As an individual, you join the local union, pay dues to the local, attend its meetings, help to elect its officers. It is the local to which you look to supervise your wage rates and working conditions, and to handle any problems which you might have regarding your work.

The local has a number of officials to conduct its business. First there are the usual officers of any club—a president, a vice-president, a secretary, and a treasurer. The president is the spokesman of the local and is responsible for the conduct of union meetings and of its affairs generally. There is also an executive board. All the officers generally work at their regular trade and put in their own time on union work; they therefore receive no salaries from the union. The same is generally true of the *shop steward* or *shop chairman*, who represents the union in a shop.

The paid, full-time official of the local is usually the *business agent* or *walking delegate*. Often he supervises several shops. He really does the day-to-day work of the local. He bargains with employers on local matters; he handles grievances for the workers; he sees to it that the union contract is observed by employers; he collects union dues and turns them over to the treasurer; he helps union members get jobs; he tries to persuade nonmembers to join the union.

THE NATIONAL UNION

The local union has a charter from the *national union*. A national union claims jurisdiction in organizing a particular type of worker throughout the country. Some unions call themselves *international* because they have locals in Canada as well as in the United States.

Unions vary widely in size. A half-dozen boast of over 500,000 members. A few have less than 1000 members. According to a recent survey conducted by the Bureau of Labor Statistics which included comprehensive studies of 197 national and international unions,

46 had fewer than 5000 members
50 had from 5000 to 25,000 members
29 had from 25,000 to 50,000 members
35 had from 50,000 to 100,000 members
31 had from 100,000 to 500,000 members
6 had 500,000 or more members.

The survey showed similar variations in the number of local branches or chapters chartered by national unions. Out of the same 197 unions—

38 had fewer than 25 locals
55 had from 25 to 100 locals
67 had from 100 to 500 locals
22 had from 500 to 1000 locals
9 had from 1000 to 2000 locals
6 had 2000 or more locals.

Altogether, it is estimated that there are between 60,000 and 70,000 locals in the United States and Canada.[1]

The national union raises funds by taxing the local unions. Each local pays to the national union a *per-capita tax,* that is, a dues payment of so much for each of its members. The local union, for example, may collect $1.50 a month as dues from its members, and may pay 50 cents a month out of this to the national union for each of the members of the local union. Not only does the per-capita tax supply funds for the national union, but also it determines how many delegates and votes each local shall have in the convention of the national union.

The *national convention* is the gathering of the delegates from all the local unions, and is the ultimate authority of the national union. It is generally held annually or biennially (every two years). At the national convention the delegates elect the officers and the members of the executive board. They also adopt resolutions approving or disapproving of the past actions of their officers, and setting forth the policies to be followed in dealing with employers. They may also take a position on problems facing the United States government, such as inflation, housing, and foreign affairs.

Once the convention has adjourned, the executive board is the highest authority in the national union. Working with the executive board are the national officers—the president, one or more vice-presidents, a secretary, and a treasurer. These are salaried, full-time officials, with great responsibilities. They travel about the country helping to organize the unorganized workers; they visit their locals to help them in their organizing campaigns and in their dealings with employers; they make contact with legislators in an effort to obtain legislation favorable to workers; they write articles, speak over the radio, and engage in other forms of publicity for the union cause.

In some industries the negotiation of contracts with employers, the calling of strikes, and other dealings with employers are handled mainly by the national union. In other cases each local deals independently with the employers, and the national union remains in the background ready to provide help—funds and leadership—if it is needed.

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[1] U.S. Department of Labor, *Labor Information Bulletin,* November, 1948, pp. 2–3.

### TYPES OF UNION ORGANIZATION AND CONFLICTING JURISDICTION

A union is organized either as a *craft union* or as an *industrial union*. A craft union includes workers who are engaged in a particular kind of work, regardless of the industry in which they work. Carpenters, for example, whether they build houses, repair the woodwork in your school, or build displays in a department store, are included in the carpenters' union. An industrial union, on the other hand, is made up of people who work in a particular industry, regardless of what kind of work they do. Workers in a men's clothing factory are included in the Amalgamated Clothing Workers of America, whether they cut the materials, operate the sewing machines, or sweep the floors. Some examples of craft unions are the unions of electricians, bricklayers, photoengravers, truck drivers, and machinists. Some examples of industrial unions are those in the automobile, steel, rubber, textile, coal, electrical-appliance, and garment industries. The craft unions are sometimes called *horizontal unions,* whereas the industrial unions are called *vertical unions.*

Sometimes unions branch out beyond their particular craft or industry, and it is difficult to see any unifying structural basis. Thus, the Transport Workers Union includes employees of the New York City subway, elevated, and bus lines; but it also includes utility workers, custodial workers at Columbia University, and aircraft mechanics at La Guardia Field. Perhaps the best example of a catchall labor union is District 50 of the United Mine Workers, which includes chemical workers, railroad workers, and many other groups.

Often unions become involved in *jurisdictional disputes*. These are disputes between two or more unions over the right to control a given type of work or workers. The carpenters' union and the plumbers' union both have claimed the right to bore holes for metal pipes in wooden floors. Both the seamen's union and the hotel and restaurant employees' union have claimed jurisdiction over the cooks on ocean liners. Often, a union seeks to enforce its claims by striking against an employer who refuses to come to terms with this union. In many instances, therefore, an innocent employer, who has signed up with one union, will suffer economic loss as a result of a jurisdictional strike. Furthermore, the offending union—and unionism in general—loses the confidence and good will of the public.

Basically, jurisdictional disputes arise because the unions desire greater membership and greater power. The larger the union, the more money it can collect in dues, and the greater its power to achieve its demands. Sometimes a jurisdictional dispute occurs out of sheer wilfulness or jealousy for personal power on the part of union leaders. These disputes are made possible by the overlapping authority of dif-

ferent unions, as in the examples given above. This, in turn, stems largely from the very nature of American industry—its complexity and its rapid change. Another underlying factor is the craft type of union organization, which is narrow in itself yet often refuses to uphold a narrow interpretation of its boundaries. An additional complication is the exceedingly broad coverage of some industrial unions.

Some attempts have been made to settle or eliminate these disputes. Interunion machinery has been set up at many points of friction. Jurisdictional strikes are now prohibited by the Taft-Hartley Act. But the problem remains a difficult one.

THE FEDERATIONS

Most of the national unions in this country belong to either the American Federation of Labor (AFL) or the Congress of Industrial Organizations (CIO). Such national unions are called *affiliated unions,* because they are affiliated with one of the *federations,* the CIO or the AFL. Those unions which are not affiliated with the AFL or the CIO are called *independent unions.* There are about 100 unions affiliated with the AFL, with a total membership of about 7,200,000. About 40 national unions, with about 6,500,000 members, are affiliated with the CIO. The independent unions, about 60 in all, have about 2,500,000 members. Total union membership in the United States and Canada, as of 1948, was 16,200,000; of these, 15,600,000 were in the United States. Some of the outstanding national unions are in the following fields (you will notice, here too, some overlapping):

| *AFL* | *CIO* | *Independent* |
|---|---|---|
| Carpenters | Automobile Workers | Coal Miners |
| Actors & Artists | Newspaper Writers | Railroad Workers |
| Teamsters (Truckdrivers) | Electrical and Radio Workers | U.S. Post-Office Workers |
| Ladies' Garments | Rubber Workers | Telephone Workers |
| Electricians | Steel Workers | |
| Musicians | Textile Workers | |
| Hotel and Restaurant Workers | Clothing (men's) | |
| U.S. Post-Office Workers | Telephone Workers | |
| Telephone Workers | | |

The functioning of the federations resembles that of the national unions. They get their funds by means of a per-capita tax. The number of members for whom the per-capita tax is paid determines how many votes each national union is allowed in the annual conventions of the

federations. At these conventions, the officers and executive board of the federation are elected and resolutions about labor and other public problems are adopted. Between conventions, the officers and executive board carry out the policies adopted by the convention.

However, the federation does not negotiate with employers about wages and working conditions. It acts mainly as a lobbying and educational organization. Through its offices in Washington, in the state capitals, and in the larger cities throughout the country, it distributes literature, conducts radio programs, and participates in various kinds of meetings and conferences—all for the purpose of educating the public and influencing government officials to support pro-labor policies. In election years it urges the public to vote for candidates who have proved friendly to labor, and to oppose candidates unfriendly to labor. The federation, like the large national unions, maintains lawyers and economists to keep it informed about political and economic developments, so that the federation and its affiliated unions can adapt themselves to the new problems that constantly arise.

The following diagram illustrates types of union organization.

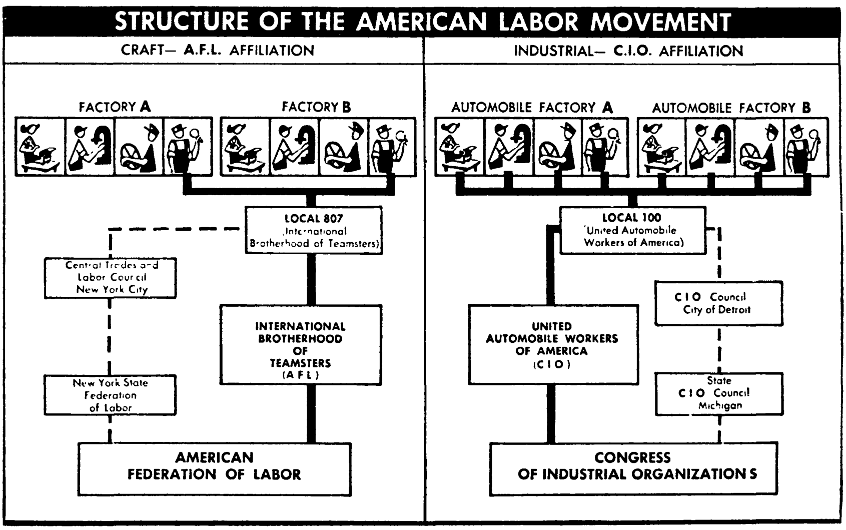


*Chart by Graphics Institute, N.Y.*

**The craft union organizes workers by skill; the industrial union organizes them by industry. Both CIO and AFL are federations of national unions, have state and municipal federations or councils. Most CIO unions are industrial unions, while the AFL includes craft and industrial unions.**

Union affiliations are also international. The CIO and the AFL belong to the International Confederation of Free Trade Unions.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | | |
|---|---|---|
| affiliated union | horizontal union | national convention |
| assessment | independent union | national union |
| business agent | industrial union | per-capita tax |
| checkoff | jurisdiction | shop steward |
| craft union | jurisdictional dispute | vertical union |
| federation | local | walking delegate |

II QUESTIONS AND PROBLEMS

1) How does the method of joining a union compare with the method of joining other organizations? Explain.
2) (a) In a table of three columns, list the major functions of a local, a national, and a federation. (b) Which is most important, the local, the national, or the federation? Why?
3) Explain how the worker is affected by the activities of the (a) shop steward, (b) president of the local, (c) president of the national union.
4) In the list of unionized industries on page 496, some industries appear in more than one column. (a) Give two examples. (b) Discuss two problems that may result from this situation.
5) (a) Explain the difference between a craft union and an industrial union. (b) Why have most of the unions that have organized during the past generation been industrial unions?
6) Should jurisdictional disputes be outlawed? Discuss.

III THINGS TO DO

1) Draw a chart based on the statistics of union membership on page 496. Note also the chart on page 538.
2) Write a report comparing two or more unions as to qualifications for membership, initiation fees, dues, functions, structure, and by-laws. Consult such sources as (a) *Directory of Labor Unions in the United States* (issued by the United States Government Printing Office, 1948). (b) *Handbook of Labor Unions* by Florence Peterson (Public Affairs Press, 1948).

## LESSON 64 UNION ACTIVITIES

### COLLECTIVE BARGAINING AND LABOR CONTRACTS

The labor union has come to be a complex institution. First in importance is the job of the union in seeking and protecting higher stand-

ards of wages and working conditions. This it does by means of collective bargaining.

The union may meet with the employers only once a year to negotiate a contract, but all year round it is engaged in preparing for these sessions. Its economists and other research experts study conditions in the industry and in the economic system as a whole. Through its newspapers and its membership meetings, it prepares the members for the forthcoming negotiations, leading them to understand the issues that are to be taken up. By publicity releases, it tries to build up public sentiment in favor of the union and its demands. In urgent situations, it

*Wide World*

**This is a photograph of a union local holding a membership meeting. Union members should participate in the activities of the union to make it serve them best. Attendance at meetings is an important obligation of members.**

distributes leaflets, advertises in the newspapers, and engages radio time.

During all these months between meetings with employers, the union seeks to strengthen itself. It conducts an organizing campaign, sending out *organizers* to persuade nonmembers to join the union. If it expects trouble ahead, it begins to raise a special strike fund.

About half of all the workers in private industry in this country are covered by union contracts; in manufacturing the proportion is two-thirds. All these workers, whether or not they are personally members of a union, are employed by firms who have signed contracts with labor unions regarding the terms of employment of their employees. Labor-union contracts have therefore become an important factor in determining the worker's way of life.

A union contract often begins by providing for some form of union security, as described in Lesson 62.

Probably most important, in the eyes of the workers, are the wage provisions. These cover not only the amount of wages but also the methods of payment, such as piece rates or time rates, special pay for hazardous or special work, and overtime rates. Some contracts call for profit sharing or a guaranteed annual wage.

Working time is defined by various provisions. Regular hours are stipulated, a minimum lunch time is set, rest periods may be provided, and vacations may be allowed in accordance with years of service.

Safety and health provisions frequently go beyond the regulations set by the state and federal governments.

Practically every contract makes some provision for job security and *seniority*. Seniority refers to the rights and privileges of a worker based on length of service. The general rule is that in reduction of working force, the last person hired will be the first laid off, and the person of greatest seniority will be the last laid off. Similar preferences apply in promotions, choice of shifts and vacation periods, and rehiring when a closed plant reopens.

A major set of provisions describes in detail the grievance procedures to be used when a worker has a complaint. (See page 509.)

### Political Activity

Unions realize that some of their goals can be attained, not by bargaining with employers, but only through the government, or at least more rapidly through the government. Often these goals go beyond the working conditions of the plant, and concern matters beyond the control of employers. Thus, the labor movement of one hundred years ago was an important factor in bringing about free public education. In more recent years public housing and price control have been demanded by many unions. In matters pertaining strictly to labor, they have supported legislation to cut the hours of work; restrict child labor; set minimum wages; and to obtain workmen's compensation, social security, and the legal recognition of unions and collective bargaining.

Unions engage in lobbying in order to influence legislators in their favor. Many unions have legislative representatives whose business it is to keep in constant touch with Congressmen and with state and city representatives.

The attitude of unions toward participation in politics has varied considerably. Among the "third-party movements" supported by large groups of labor have been the Workingmen's Party of the 1820's, the Greenback Labor Party of 1878, the La Follette Progressive Party of 1924, and such recent state groups as the American Labor and Liberal

Parties. The American Federation of Labor has generally opposed the organization of a separate party for labor. Its slogan has been "reward your friends and punish your enemies," regardless of party affiliation. The CIO has been more favorable to partisan political action; although it has supported candidates of both major parties, it has in some cases been more willing to participate in the organization of labor parties in states where such action has been considered fruitful. With the passage of the Taft-Hartley Act, a revival of interest in politics occurred in both the AFL and the CIO. Both the CIO and the AFL now have permanent supplementary organizations—the Political Action Committee (PAC) and Labor's League for Political Education, respectively—for the purpose of carrying on political activity.

### Other Activities of Unions

Back in the 1930's a delightful musical show called *Pins and Needles* ran for two years on Broadway. The members of the cast were amateurs, members of the International Ladies Garment Workers Union. Many people were astounded at the realization that a labor union was interested in other matters than calling strikes and lobbying for favorable laws.

But this was only one example of the numerous extra services that modern progressive unions provide for their members. Recreational and cultural activities are widespread. Unions have basketball, soccer, and baseball teams, and billiards, bowling, and handball. Union members who are musically inclined can participate in choruses, orchestras, and shows. In intellectual fields, there are forums for discussion of current events, as well as courses in art, public speaking, and literature. There are also courses for technical training in the jobs of the workers.

*Workers' education,* in a narrower sense, has as its major objective the development of more intelligent and more active union members. Hence many unions teach the workers about unionism and their own particular union—its history, its aims, its methods. Some require new members to take such courses. In addition, courses in economics and in government are customary. Many workers study parliamentary law in order to learn how to participate more effectively in union meetings. Special classes are conducted to train shop stewards and other union officials in the methods of handling grievances.

An increasing number of unions try to do something for their members as consumers. They have, as you have read, carried on political activity in support of price control. A few unions have organized consumers' coöperatives. Some have credit unions which lend money at low rates of interest. The Amalgamated Clothing Workers of America has several low-rent housing projects. The International Ladies Garment

Workers Union has a summer resort at which union members may stay at low rates.

Individual security is the purpose of much of the activity of the unions. We are already familiar with the usual objectives, such as high wages, freedom from arbitrary discharge, and the closed shop. In addition to these, and as a supplement to the government's program of health services and social security, some unions provide life insurance, pensions, unemployment benefits, hospitalization and medical services. The Printing Pressmen's Union has a sanitarium in Tennessee.

A recent innovation is the group of activities known as *community services*, which are welfare activities for individual members and for the community. One major aspect of this is *union counseling*. The union counselor advises members on such varied personal problems as where to get psychiatric guidance for a maladjusted child; where to obtain free legal aid for a lawsuit; where to get free or inexpensive medical care; how to collect unemployment benefits or old-age pensions; and where to play billiards or checkers, or do social dancing, either free or at a low fee. As a union leaflet has explained, "members and their families need health and welfare services just as they need adequate take-home pay—and they need their union behind them to make sure they get them." Another major aspect of the unions' community services is their active participation in the affairs of their community. Many of them contribute generously to charitable causes; in many communities the Community Chests are sponsored by joint committees of labor and management. Some unions are active in the movement that is generally known as "intercultural education." They often give moral and financial support to causes that involve civil liberties. Through this program, a triple objective is achieved: the union serves its members and their families; both the union and the members serve the community; and the members become more loyal supporters of the union.

### Union Leadership and Membership Participation

Many unions are large organizations, in membership, in dues income, and the scope of their activities. Large unions face the same problems of social responsibility as large-scale businesses. When an organization is large and powerful, the way in which it uses its power becomes a matter of public concern.

Labor union leaders have much power. Their decisions in contract negotiations, and in strike situations, affect the economic welfare of many workers, the employers, and the community as a whole.

Some labor leaders receive large salaries. This may make them anxious to stay in office, so that they can continue to receive these incomes. The unions, in defending high salaries for their officers, point out

that men like John L. Lewis, David Dubinsky, Philip Murray, or William Green possess qualities comparable to those of big-business executives. Moreover, they are at the head of organizations that are in many ways as big and as important as our huge corporations, and deal with problems that are as difficult. Some people feel, however, that big salaries to union officers are socially unjustified, because they should not get too far away from the workers whom they lead.

Some labor leaders have established a dictatorship within their unions. In a recent court case in New York State, it was shown that in a certain union there had been no election of officers for thirty years. Sometimes elections are meaningless. The officers control the election machinery and count the ballots as they wish. If members try to criticize the officers or oppose their policies, the chairman may simply refuse to recognize them at meetings; they may be shouted down by a well-disciplined group; they may be bribed or coerced into silence. The leaders can hand out offices in the union and may even be able to dictate who obtains employment in the industry.

Sometimes union officers misuse union funds. Some get themselves voted huge salaries, bonuses, and gifts. Special assessments may be charged for purposes which are not carried out, and the officers may keep the money for themselves. Such corruption is made easier in some instances, by lack of adequate accounting of union funds to the membership.

*Union racketeering* covers a multitude of sins and is difficult to define. Perhaps as good a definition as any is, "the private enrichment, by various coercive and corrupt tactics, of union officials at the expense of workers, employers, and the public."[1] Some examples of racketeering against the workers are these: "stealing from the union treasury, accepting graft from members in return for jobs, or the use of strong-arm men to crush dissent within the union. . . ." Racketeering against employers and the public includes "graft given a union official by an employer to avoid a threatened strike, settle an existing strike, or avoid a clause of an agreement. Or union leaders may engage in business, using the threat of strikes to force employers to purchase supplies from them. In extreme cases, professional gangsters may muscle into a union and by force and intimidation compel their election to office or the election of puppets chosen and controlled by them."[2]

In some instances, organized political minorities have been able to

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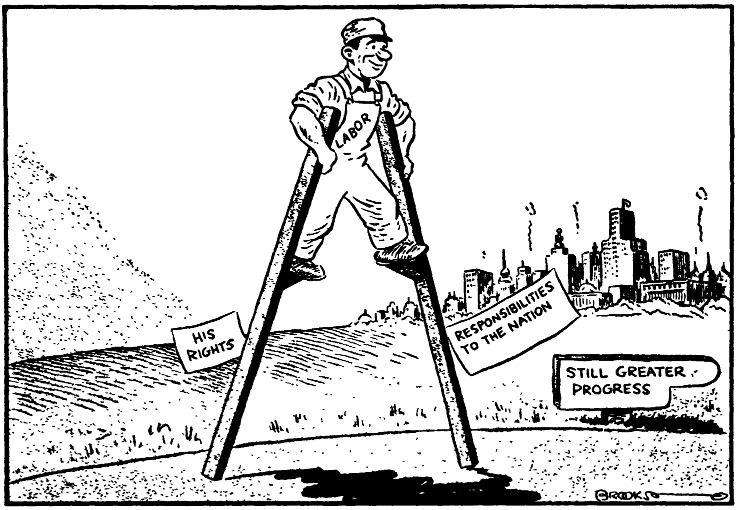
[1] C. R. Daugherty, *Labor Problems in American Industry*, Houghton Mifflin Company, 1938, p. 492.

[2] Joel Seidman, *Union Rights and Union Duties*, Harcourt, Brace and Company, 1943, p. 112.

get control of unions and lead them into positions that are detrimental to the best interests of the members, the unions, and the general public. It is all the easier for them to attain control when many members do not attend meetings or do not interest themselves in the affairs of their union.

Just as in the business world and in government, large-scale operations require specially competent, responsible, and honest leadership. Union officials today must understand politics and economics; they




*Brooks in* The Birmingham News

**Labor's power and its responsibilities grow together.**

must be good executives; they must be brave fighters and shrewd bargainers. In addition, they must be completely loyal to the union and its members, democratic in spirit, and beyond corruption. The demand for this kind of leader is greater than the supply. Some unions, as we have seen, are attempting to organize systematic training for young people who may be interested in working as labor executives.

Most important, however, is the quality of the union membership. Members should be active and alert and should attend meetings regularly. They should examine carefully all reports submitted by officers and committees, and they should insist upon the auditing of the union's records by independent accountants. When the members do these things, it is difficult for any union leader to neglect the interests of the union. Membership in a union gives the individual worker the strength which comes from unity; but it also gives him the responsibility of doing his share in running the union effectively, honestly, and wisely.

## Exercises and Activities

### I Dictionary of Economic Terms

community services
organizer
racketeering
seniority
union counseling

### II Questions and Problems

1) A modern union is more than a bread-and-butter organization. Explain.
2) If you were a union organizer, what arguments would you use to convince a worker that he would get his money's worth from the union?
3) Discuss the following policies in regard to a union in politics: (a) the union should stay out of politics; (b) the union should support an independent labor party. (c) the union should reward its friends and punish its enemies.
4) The American Civil Liberties Union states: "The increasing responsibilities placed on trade unions by governmental protection of their democratic rights demand that they in turn accept the responsibility for the democratic conduct of their own affairs." (a) What practices on the part of some unions and union leaders may be criticized as undemocratic? (b) Describe specific ways in which unions may carry out "the responsibility for the democratic conduct of their own affairs."

### III Things To Do

1) Choose any union as a case study. Find out all you can about its activities, and report to the class.
2) Report on the history of third parties in America. To what extent did labor take part in these movements?
3) Find out about the work of the Workers Education Bureau and the American Labor Education Service, with headquarters in New York City.
4) Read and report on any of the following: (a) *Union Rights and Union Duties* by Joel Seidman (Harcourt, Brace, 1943). A clear, well-balanced treatment of the moral and legal rights and duties of unions. (b) *Worker Education Today* by Mark Starr (League for Industrial Democracy, 1941). (c) *Labor Unions in Action* by Jack Barbash (Harper, 1948).

## LESSON 65 PEACEFUL SETTLEMENT OF LABOR DISPUTES

### Drawing up a Trade Agreement

For every strike, there are perhaps a thousand labor disputes that are settled peacefully. The strike makes the front-page headlines, while the peaceful settlement is tucked away in an inside page or does not rate any news item at all. However, peaceful settlement is of tremendous significance, by whatever measure it is rated—by the number of disputes settled, by the number of workers affected, by the amount of production uninterrupted, by the strengthening of labor and management morale.

Labor disputes between union and management may be studied at two different stages. One is when the two sides are considering the terms of employment of the workers. The other is when, after an agreement on terms of employment has been reached, questions arise as to the way in which the agreement should be carried out.

Let us consider the first of these two stages. Periodically, in most cases annually, the employer and the union representatives meet to draw up a contract regarding the terms of employment: wages, hours, and working conditions. Negotiations begin with each side's presenting its demands, backed by arguments and statistics of wages, profits, cost of living, and the like. Sooner or later a compromise is reached. The end result is a *trade agreement,* a contract between the employer and the union, embodying the terms of employment and the methods of enforcing it. After the agreement is drawn up, it may have to be submitted to the union membership for ratification, if the union constitution so requires.

Negotiations for a new contract may take many days, even weeks and months. In July 1948, *The New York Times* and the Newspaper Guild of New York signed a contract after eight months of negotiations and two years of discussions of job classifications. More than 200 joint meetings of *Times* and Guild committees had been held, in addition to separate meetings of each of the committees.

When the two sides find it impossible to agree, a third party may be brought in to help them come to terms. He may be invited in by the disputing parties, or he may take the initiative in offering his assistance. The third party may be a government official or some private individual. Our federal government has established the Federal Mediation and Conciliation Service. In this agency are specially trained men who are sent around the country wherever major labor disputes occur. In addi-

tion, many states and cities have their own agencies to handle local disputes.

The third party brings the employer and the union together for negotiation. This is called *conciliation* or *mediation.*[1] First he gets the union to state its demands and the employer to state what he is willing to offer. Then he shuttles back and forth between the two parties, reasoning with them and trying to arrange a compromise.

If mediation fails, or in place of mediation, the parties may submit


Labor Information Bulletin, April, 1947

**Labor conciliation, a new profession, requires a high order of skill.**

their case for *arbitration*. The third party (the individual or group chosen as arbitrator) hears the dispute and renders a decision. The disputing parties agree beforehand that the decision of the arbitrator shall be binding, and also that there shall be no strike or lockout while the arbitration is taking place.

There has been some discussion of the need for *compulsory arbitration.* This would mean a law requiring both sides to submit to arbitra-

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[1] Sometimes a technical distinction is made between conciliation and mediation. The former involves active participation by the third party in the negotiation, whereas the latter involves merely carrying the parties' demands from one to another.

tion; awards would be binding, and strikes and lockouts would be prohibited. Some people feel that this would be desirable, particularly in performance of work that is necessary to the health and safety of the public, such as running hospitals, operating railroads, and coal mining. The unions oppose this idea on the ground that, as life becomes more complex, the industries and occupations that may be considered essential to health and safety become increasingly numerous. At this rate, argue the unions, it would soon be illegal for workers in most industries to strike. The advocates of compulsory arbitration contend, in reply, that this right of the individual must be subordinated in some instances to the superior rights of the public. In opposition, again, it is argued that collective bargaining yields results that are more acceptable to the disputing parties and hence provide a more lasting peace. In general, businessmen as well as unions are opposed to compulsory arbitration, since they see in it an invasion of our economic freedom. Moreover, businessmen realize that compulsory arbitration awards can be more easily enforced against them, through seizure of business properties, than against large masses of workers.

A special situation arises in wartime, when the national emergency makes it particularly important that production should not be hindered by industrial disputes. At the same time it is highly desirable that workers should be contented as an incentive for doing good work. During World War II, the President was empowered to take over any plant where a strike or a lockout impeded the war effort, and then the working conditions prevailing before the disagreement had to be maintained.

Our federal government has an elaborate system of government intervention in railroad labor disputes. It provides services for mediation and voluntary arbitration. If these fail, there may be resort to *compulsory investigation.* Once the President appoints a Board of Investigation, no strike or change of working conditions is permitted for 60 days. During this time the Board investigates the facts of the case and recommends a settlement to the President. Thereafter reliance is placed upon the pressure of public opinion to get the controversy settled. The Taft-Hartley Act has a similar provision for national-emergency situations.

### Settling Disputes That Arise Under the Trade Agreement

After an agreement has been reached, it is essential that disputes arising during the period of the agreement be settled peacefully. There must be a machinery of enforcement and of interpretation.

First, the terms of the agreement need to be enforced. Someone must have the responsibility to see that the workers are not made to work longer hours than agreed, that they get the required extra money for overtime and any other benefits agreed on. This is not only for the pro-

tection of the individual workers. It is also for the benefit of the honest employer who needs protection against competing employers who may be less scrupulous. Likewise, someone must have the responsibility to see that the workers live up to their part of the bargain, that they give a full and fair day's work.

Second, there must be a way of settling workers' complaints and solving their problems. The workers complain, for example, that because of poor ventilation, they are suffering from headaches. Frank Wilson has been discharged for alleged incompetence, but feels that the real reason is that the foreman wanted to create an opening for one of his friends. Some piece-rate workers feel that, because the firm is slow in supplying materials and repairing the machines, their earnings are lower than they should be. These complaints and any others that arise in connection with the enforcement of the labor contract are called *grievances*.

The enforcement of contract terms and the settlement of grievances are handled through whatever grievance procedures have been created in the contract. The complaining individual calls in the shop chairman, who tries to settle the matter amicably with the foreman. If this fails, an appeal may be taken to a joint board or trade board, which is a committee of representatives of the union and the employer.[2] These men are not directly involved in the dispute and will consider it more objectively. Finally, where the dispute is a major one—if it affects a large number of workers or involves an important matter of principle—either side may appeal the decision to a board of arbitration. On this board, in addition to the representatives of the union and of the employer, there is a third person agreed upon by them. Or the final arbitration may be done by the single arbitrator appointed by both sides. The decision of the arbitrator is legally binding.

This arbitrator may be named especially for the occasion when a dispute arises; or he may be appointed in advance, ready to take up any case when it arises. In the latter situation, he is usually a full-time employee, whose salary is paid by both sides. He is often called an *impartial chairman* of the industry, or referee, or umpire.

Second, there often arises the need for interpretation of the agreement as it is being enforced. The laws of the industry are general statements and therefore need constantly to be interpreted in their application to specific cases. For example, after having stipulated in the contract what the wage rates on piece work shall be, the parties will often have differences of opinion as to interpretation. A shop may change the type of product it makes, styles may change, different com-

[2] The term "joint board" is sometimes used to refer to a committee of representatives of different unions.

panies within one industry may have different ways of doing a given job. Here is one example of a difference of opinion in the Chicago clothing industry:

> The union complained that the firm had reduced the brushing rate on Palm Beaches without the consent of the union and requested the restoration of former rates. The firm contended that it had always paid the lower rate for Palm Beach coats and that the higher had been paid only for half and quarter lined coats. The Trade Board found that the case turns on the facts, which the firm feels can be checked up by an analysis of payroll and production records. The Board directed that this be done, promising to review the case if it were not disposed of by such an analysis.[3]

### A New Profession: Labor Negotiation

It should be apparent that the process of collective bargaining requires specialists and experts. The men who face each other over the negotiation table must be well informed about such matters as methods of production, job specifications, the profit rates of the industry and of specific employers, the probable effects on production of a proposed change in hours of work, and so on. To do their job adequately, they must be able to think clearly and to argue their cause logically and persuasively. They should understand psychology, knowing how to deal with colleagues and with opponents. It helps, too, in an intangible way, if the negotiator is a man of general culture and understanding.

Both sides are represented by specially trained men and women. Some are trained in industrial and labor colleges, such as those at Cornell and Harvard, where they go through a full course, specializing in economics and particularly in labor-management problems. Others are trained in the "college of hard knocks," with years of experience in learning the trade, learning how to deal with men, and learning how to express themselves and convince others of their point of view.

In the well-run business organization, the counterpart of the union representatives is found in one or more types of labor specialists, whose special job it is to negotiate with the union's representatives and to achieve the best possible relations with the men on the job. A large corporation may have a vice-president in charge of labor relations. In addition, many of the supervisors may be given special training in methods of handling workers' complaints satisfactorily.

Assisting also in the process of collective bargaining are numerous hired experts. Economists keep the parties posted on the trends of the times, and advise them about the proper position to take in negotiations. Engineers study the processes of the industry and suggest im-

[3] The Chicago Joint Board, A.C.W.A., *The Clothing Workers of Chicago*, Chicago, 1922, p. 303.


*Poinier in* The Detroit Free Press

**Collective bargaining can be a means of avoiding labor conflict.**

provements. Psychologists may be consulted about the effects of welfare programs and other measures on morale.

### A New Era in Labor Relations

The history of the development of collective bargaining is a story of the transformation of industry from autocracy to industrial democracy. In an industry where the trade agreement prevails, the worker has a voice in making the rules that govern his working life. His job is no longer subject to the whims of a single individual and he cannot be fired on the slightest pretext; he has taken long strides toward achieving the "freedom from fear" that is part of our modern economic bill of rights. He has a property right in his job and feels secure. He can expect fair play, according to the rules of the game.

Nor is this gain from industrial democracy by any means one-sided. The free worker develops a sense of loyalty to the industry and the shop in which he has a stake. The management, it is true, gives up the right of arbitrary action. To that extent it may seem to lose the efficiency that comes with the absolute right to hire and fire and to give orders that cannot be questioned. But a more fundamental and more lasting efficiency is thus attained. Under the antiquated procedures, the workers gave vent to their bad feeling in frequent sudden stoppages, malingering, restriction of output, and high labor turnover, all of which raised the employer's cost of production. Under a trade agreement, the union undertakes to discipline its members and to prevent individual interference with production.

Employers gain, also, by the greater uniformity of labor standards that exists under trade agreements. As far as possible, the union will seek to establish similar conditions for all its members. In this way, businessmen are relieved of one of their major headaches, namely, the possible competitive advantage attained by those who employ their workers under inferior conditions.

Finally, the gains to society are not to be overlooked. Trade agreements bring long reigns of peace in the industries where they prevail. The public gains much when stores, factories, mines, and railroads run smoothly without the interruptions caused by labor-management strife.

Why, then, do some employers still resist the efforts of unions to have a continuous voice in the labor relations of the plant? The trade-agreement procedure represents an intrusion in the field of management. Some employers regard this as an unjustified interference with their affairs. Furthermore, they fear that giving the union a voice in a few things will sooner or later lead to complete domination of the business by the union.

In recent times, more and more employers have accepted the view that trade agreements can be used to serve the common interest which employer, worker, and the general public have in peaceful and just labor-management relationships.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| arbitration | conciliation | mediation |
| compulsory arbitration | grievance | trade agreement |
| compulsory investigation | impartial chairman | |
| | joint board | |

II Questions and Problems

1) A union and an employer have a wage dispute. Explain the different methods by which the dispute may be settled.
2) (a) Explain what a trade agreement is. (b) Summarize the matters which would be dealt with in a trade agreement.
3) (a) Explain what a grievance is. (b) Describe a typical grievance procedure.
4) Discuss the extent to which trade agreements mean (a) restraint on freedom of enterprise, (b) industrial democracy.
5) "Ownership of a clothing factory at one time conferred upon the employer almost unlimited personal authority over the lives and happiness of the workers in his employ. Today, its claims are being increasingly subordinated to the needs of the industry as a joint enterprise and a public utility." (From *The Clothing Workers of Chicago*, ACWA, p. 191.) (a) Explain this statement. (b) How has the nation gained from this development? (c) What problems have been created by this development?
6) "Employers have come to recognize that the elimination of waste and the promotion of efficiency which result in lower costs are just as much a human problem as a technical problem." (*Labor Problems in American Industry* by C. R. Daugherty, Houghton Mifflin, p. 592.) (a) What is the "human problem" in this statement? (b) How has the machinery of collective bargaining helped to eliminate waste and promote efficiency? (c) How may collective bargaining increase waste and reduce efficiency?
7) Write an essay on "Industrial Democracy through Collective Bargaining."

III Things To Do

1) Follow a current labor dispute in the newspapers. Write a summary of the issues and events, and show how mediation and arbitration may have been used in bringing about a settlement.
2) Find out about the work of the American Arbitration Association (9 Rockefeller Plaza, New York 20, N.Y.).
3) Read and report on the War Labor Disputes Act (Smith-Connally Anti-Strike Law) of World War II. What is your opinion of this law?
4) Read and report on any of the following: (a) The April, 1948, issue of *Industrial Bulletin*, monthly news magazine of the New York State Department of Labor. This issue explains and dramatizes the processes of labor-management relations. (b) Chapter 8 of *The American Story of Industrial and Labor Relations*, New York State Legislative Committee on Industrial and Labor Conditions, 1943. A simple treatment. (c) *The Clothing Workers of Chicago* (Chicago Joint Board, ACWA, 1922). A dramatic account of the origin and functioning of collective bargaining in this industry. (d) *Management-Union Arbitration* by Maxwell Copelof (Harper, 1948). This is a realistic

"record of methods, cases, and decisions," written by an impartial arbitrator.

# LESSON 66 LABOR-MANAGEMENT CONFLICT: UNION METHODS

## THE STRIKE

We have seen that today most labor-management disputes, by far, are settled by peaceful processes of collective bargaining. However, when negotiation fails, the two sides gird for battle. The *strike* is the major weapon in labor's arsenal. It is a stoppage of work by a combination of workers, who attempt to keep their place as employees. The second half of this definition is significant, for it emphasizes the point that the workers consider this a temporary stoppage and not a resignation from their jobs. The aim of a strike is to bring about a loss of business to the employer and consequently a need to settle with the union.

A *sympathetic strike* is called as a means of supporting a strike of other workers. If the bricklayers are out on a strike, a sympathetic strike by the electricians will be a great help in forcing the construction contractor to come to terms. In a *sit-down strike,* the workers, although stopping work, stay in the plant. Thus they make it impossible for the employer to hire other workers in their place. In this case they carry to an extreme development the idea that the jobs are still theirs and that they are merely stopping work temporarily. Sit-down strikes have been rare, and the courts have held them to be illegal.

An *unauthorized strike* is one which is called in violation of an agreement. The latter is usually of the *wildcat,* or *outlaw,* type, which is called by a group of irresponsible workers in opposition to the wishes of the union and its officials. Outlaw strikes are condemned by union officials as bitterly as by employers. Sometimes, however, there is room for an honest difference of opinion as to whether a strike is authorized or not. Sometimes a prohibition of strikes by law or contract can be evaded by a *slowdown,* staying on the job while deliberately limiting production.

In order to make strikes more effective, unions use various supplementary devices. *Picketing* is the most familiar of such devices. The workers or their sympathizers march outside an establishment to advertise the labor dispute. Signs are carried which state the workers' message. Picketing may take place even when there is no strike, in order to publicize the demands of the union and criticize the employer for his unfairness, from the union's point of view. The objective is to persuade

customers not to buy and to keep workers from entering the plant. Sometimes, in order to impress nonstriking workers and the public with the solidarity of the strikers, they engage in *mass picketing* by forming a long line or a solid group around the plant. In extreme instances they block the entrance to the plant, thus making it difficult, if not impossible, for workers and customers to enter. Mass picketing is of questionable legality. Often, however, it is a matter of serious dispute as to how many pickets, and what particular formation, are necessary before it can be considered mass picketing.


*Wide World*

**Pickets form a line around the gates of a corporation. Note the signs referring to wage rates and seniority privileges, which were issues in the strike. Does this appear to be mass picketing?**

The courts have repeatedly upheld picketing as a constitutional right. But there have been frequent complaints about some types of picketing. The problem of mass picketing has already been mentioned. Sometimes pickets claim that the workers in a plant are on strike, when they are not. Sometimes pickets shout abusive epithets at the employer and the nonstriking workers. Occasionally pickets resort to threatened or actual violence.

Sometimes workers who have a grievance "strike on the job." They find all sorts of occasions and excuses for slowing down; they do careless work and turn out slipshod products; they "gum up the works" as much as possible. An extreme practice is *sabotage.* The word is derived

from the French "sabot," meaning "shoe": dissatisfied workers would somehow get their shoes caught in the machinery, with obvious results. In a recent dispute between motion-picture theaters and projection operators, the workers, although staying on the job, showed their annoyance by running the films upside down and making weird wails come out of the sound track. However, sabotage is much rarer today than in the days when peaceful settlement of disputes was the exception rather than the rule.

### The Boycott

The strike, in and of itself, is sometimes ineffectual. The employer may be able to hire other workers to take the place of the strikers. In any event, he may be able to hold out against serious financial difficulty longer than the workers can hold out against starvation. Therefore, the workers use various devices to bring pressure on the employer to come to terms.

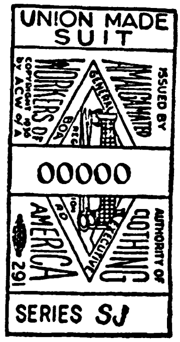
Not only when a union goes out on strike, but also when it has been unsuccessful in organizing the workers in a plant, it tries to hit the employer where it hurts his income. A *boycott* is an organized refusal to patronize a seller. We have seen that one of the main purposes of picketing is to advocate a boycott. A boycott may also be sought through newspaper advertisements and publicity in union journals.

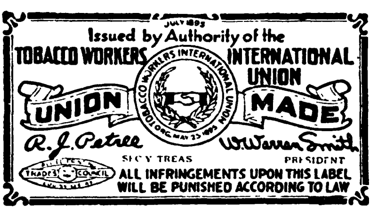
The law makes an important distinction between two types of boycott. The *primary boycott* is directed against a businessman who is directly involved in a labor dispute. For example, consumers are asked to boycott a store where the workers are on strike. The *secondary boycott* is directed against a businessman who, though not directly involved in a labor dispute, deals with a firm that is so involved. For example, consumers may be asked to boycott a store that sells the products of a nonunion manufacturer. Or workers on a building job may refuse to handle stone cut by nonunion labor. In former years, union publications used to carry *unfair lists,* giving the names of employers who were supposedly unfair to labor and who, the unions claimed, should be boycotted.

Boycotts today are rare, except as they are incidental to strikes against retail businesses, which sell directly to consumers and can easily be boycotted by them. There is some doubt as to the effectiveness of the boycott procedure. Particularly in a boycott involving large manufacturers and large numbers of workers, as in steel and rubber, the type of product is such that it is difficult to carry out either a consumers' or a workers' boycott. Furthermore, the federal courts and most state courts have held some boycotts, particularly the secondary boycott, to be illegal. Probably the most famous case involving a boycott was the one in which the hat workers of Danbury, Connecticut, in 1908, were compelled by the courts to pay large damages to their employer, on the

ground that the boycott was an unlawful conspiracy. The Taft-Hartley Act of 1947 prohibited the secondary boycott.

A very similar tactic, though in reverse, is the *union label*, which has been called a "negative boycott." Instead of attacking unfair or anti-union employers, the union's purpose here is to give publicity to the friendly employers. Employers are asked or permitted to place on their goods labels indicating that these goods are produced by union workers. By means of advertising and publicity, the union and the employer seek to obtain consumer preference for such products. The union label



**In the lower right corner is a reproduction of the barber's union card. The other three are union labels appearing on or with the product.**

is most effective on goods that are bought directly by consumers rather than by business firms, and particularly goods bought largely by workers and their friends. Thus the labels of the bakers, the printers, the brewery workers, and the garment workers have won wide recognition.

The following is a typical appeal to union members, in the *American Federationist*, the official publication of the AFL:

HOW DO YOU SPEND YOUR MONEY?

THE DOLLARS you earn each week are union-earned dollars. When you spend those dollars, it is to your own self-interest to make sure that the goods and services you buy merit a trade unionist's patronage.

Union-made goods and union-rendered services are consistently tops in value, so you obtain the most for your money when you insist upon such commodities and services.

Tell your friends and neighbors to look for the union label, union shop card and union service button. They'll be grateful for the suggestion.

RESTRICTION OF PRODUCTION

Although not strictly in the same category as the strike and the boycott, restriction of production may often be used as a device for attaining some of the workers' goals. The specific methods used and the particular aims are of a great variety. It is the sort of practice that has been going on for ages, with and without union organization.

One method is the limitation of the supply of workers. The purpose is to create a scarcity of labor and hence to induce a rise in wages. Among the specific practices that fall under this head are the closed union and high initiation fees, which have already been discussed.

Quite similar in purpose is the practice known as *featherbedding*. This term applies to union work rules which limit the maximum utilization of manpower or of machines. The aim, and the net effect, is to create a greater number of jobs than are actually needed to perform the work. Painters limit the size of brushes and prohibit the use of paint sprayers. The musicians' union, amongst others, requires in certain circumstances, the employment of standby workers, who do no work, but must be employed in order to meet a required quota. The electrical workers' local of New York has often required that electrical equipment, after delivery to a construction job, be taken apart and reassembled on the job.

Some forms of featherbedding were prohibited by the Taft-Hartley Act. But there is always the problem of proving when a certain rule becomes featherbedding. For example, the rewiring rule just mentioned has been defended as a necessary precaution against fire, and paint spray is alleged to be injurious to the health of the workers, as well as producing an inferior job.

Although there is much criticism of featherbedding as a social waste, there is widespread realization that behind nearly all featherbedding is the workers' belief that these rules are necessary to protect their jobs. Some unions, with the coöperation of employers, have undertaken to solve the problem of technological unemployment in ways that are more in keeping with social progress. The Amalgamated Clothing Workers got some employers to agree to a dismissal wage of $500 for every cutter thrown out of work by the cutting machine. Other unions require, when a new machine is introduced, that their members receive first opportunity for training and hiring at the new task. There are

many cases, indeed, of unions actually coöperating with employers in introducing labor-saving and other efficiency devices.

### Political Activity and Propaganda

Often unions find it necessary or desirable to appeal for outside help in improving labor conditions. Legislation is sought for better wages and hours and for the protection of the union. Unions engage in lobbying and support friendly candidates in political campaigns. (See Lesson 64.)

To influence the government and also to obtain favorable public opinion, unions use various propaganda devices. Picketing involves propaganda. Sometimes unions state their case in newspaper advertisements. When the Taft-Hartley bill was pending before Congress, the unions publicized their opposition by radio programs using the members of the screen, radio, and actors' unions, in one of the most powerful propaganda campaigns in labor history.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| boycott | primary boycott | sympathetic strike |
| featherbedding | sabotage | unauthorized strike |
| mass picketing | secondary boycott | union label |
| outlaw strike | sit-down strike | unfair list |
| picketing | strike | wildcat strike |

### II Questions and Problems

1) The American worker regards the right to strike as an "unalienable right." (a) Why? (b) Are there any circumstances under which, in your opinion, the right to strike should be limited? Give reasons for your answer.
2) "A worker has a property right in his job; when he strikes, no one should be allowed to take his place." What do you think of this proposition?
3) (a) Show how the union label is a boycott "in reverse." (b) Would you be influenced for or against a product by a union label? Why or why not?
4) (a) Summarize the arguments which have been used to justify work rules which limit production. (b) Summarize the criticisms which have been made of these rules.
5) In what ways could labor, management, and government coöperate to eliminate featherbedding?

6) (a) What is the difference between a primary boycott and a secondary boycott? (b) Do you believe boycotts should be used by workers? If so, to what extent? In your discussion show the viewpoints of labor, management, and the public.

III THINGS TO DO

1) Read and report on the sit-down strikes in the early history of the CIO. (See the readings listed on page 540.)
2) Bring to class examples of appeals to the public by workers on strike. Do you think its appeal to the public is effective?
3) Read and report on the story of the Molly Maguires, the coal miners who made a regular practice of violent methods.
4) Bring to class examples of union labels. See if you can find whether these labels have any effect on the sale of the products.

# LESSON 67 LABOR-MANAGEMENT CONFLICT: MANAGEMENT METHODS

### THE CONSPIRACY DOCTRINE

During the early days of the Industrial Revolution, unions did not have the positive legal right to exist. They were declared conspiracies in restraint of trade under the common law. After unions did receive legal recognition, their specific aims and activities, such as picketing, boycotts, and the closed shop, remained under a shadow of doubtful legality.

After a while came the antitrust laws. The Sherman Act of 1890 outlawed "every contract, combination . . . , or conspiracy, in restraint of trade . . . among the several states. . . ." Although the law made no specific mention of labor combinations, the words were broad and general enough to include them if the courts chose to do so. And the courts did choose to do so. In the Debs case (1895), a federal court issued the first important labor injunction in our history. Things came to a climax in the Danbury Hatters' Case (1908), in which a boycott resulted in the employer's being awarded close to $300,000 in damages against the United Hatters' Union. The union treasury was exhausted, and the individual members of the union had to pay the balance; many of them lost their property as a result. The Danbury Hatters' Case threw the unions into a state of fear and anxiety. Unions could not be sure of the legality of any of their activities, and their very existence was threatened by possible damage suits. As more and more cases were decided

against them, they became more and more insistent that the Sherman Act be amended.

When the Clayton Act was passed in 1914, Samuel Gompers, president of the American Federation of Labor, hailed it as labor's Magna Carta and Bill of Rights. Section 6 stated that "Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor organizations . . . or to restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall such organizations be held to be illegal combinations or conspiracies in restraint of trade."

There has been a good deal of controversy over the real meaning and intention of these provisions. It was not long, however, before labor's jubilation over the Clayton Act came to an end, as the prosecutions for conspiracy increased. Although the unions were no longer considered conspiracies in themselves, some of their activities were so regarded by the courts. This hostile antiunion atmosphere encouraged employers to fight labor organization.

### Fighting Against Union Organization

One way in which employers tried to keep their workers from joining or staying in a union was the *blacklist*. Employers drew up a list of names of workers who were to be refused employment by any of them, and the list was circularized throughout the industry. Usually the names were those of workers who were engaged in union activities.

In order to find out who the union members were, particularly the active ones, and to find out the union's plans, employers used spies, or *espionage*, in the plant and in the union. A characteristic procedure was the use of private detective agencies. The system of espionage went beyond spying and making use of the information to fire union members and to prepare against strikes. The spies worked secretly to break up the union, by causing disagreements, factions, resignations of officers, and decrease in membership. Often, pretending to be the most ardent and revolutionary among the unionists, they encouraged violence among strikers in order to justify violence and other drastic measures on the part of employers and the police.

Most large employers operated their plants on an open-shop basis, which in practice really meant an antiunion shop. This was frequently accompanied by the *yellow-dog contract* When a man sought employment, he was required to sign an agreement stating that he did not belong to, and did not intend to join, any union during the term of his employment. Such contracts were for many years an insuperable obstacle to union organization in many industries. The United States

Supreme Court held that it was illegal for a union to solicit members among employees who had signed such a contract.

Some employers, finding the desire for union organization strong among their men, organized *company unions.* These differed from genuine unions, in two major respects: first, they were strictly limited to the workers in a single company or a single plant; second, they were dominated by the employer. (The company union is to be distinguished from an *independent union,* which in some cases may also be limited to a single company or plant, but is free from employer control.) The devices used for dominating the union were varied. Thus, the company might give them a meeting place on company premises, and often the employer or his foreman was present at union meetings. The employer might assist in the running of union elections, and would pay the union expenses.

It is now illegal for employers to interfere with the unionization of their employees. The Norris-LaGuardia Act of 1932 made yellow-dog contracts unenforceable, and the National Labor Relations Act of 1935 outlawed the blacklist, espionage, and the company union.

Sometimes employers have used much less direct methods. Such, for example, is their *welfare work,* which consists of "all those services which any employer may render to his work people over and above the payment of wages and which are not directly related to their job efficiency." Employers may provide lunchrooms with free or cut-rate meals; baseball fields, or other recreational facilities; dances and other social affairs; savings and loan plans; pensions, life and health insurance; and profit-sharing plans. The motive of the employer may be purely humanitarian, or to encourage labor efficiency, or to make the workers feel that they do not need a labor union.

### Fighting Strikes

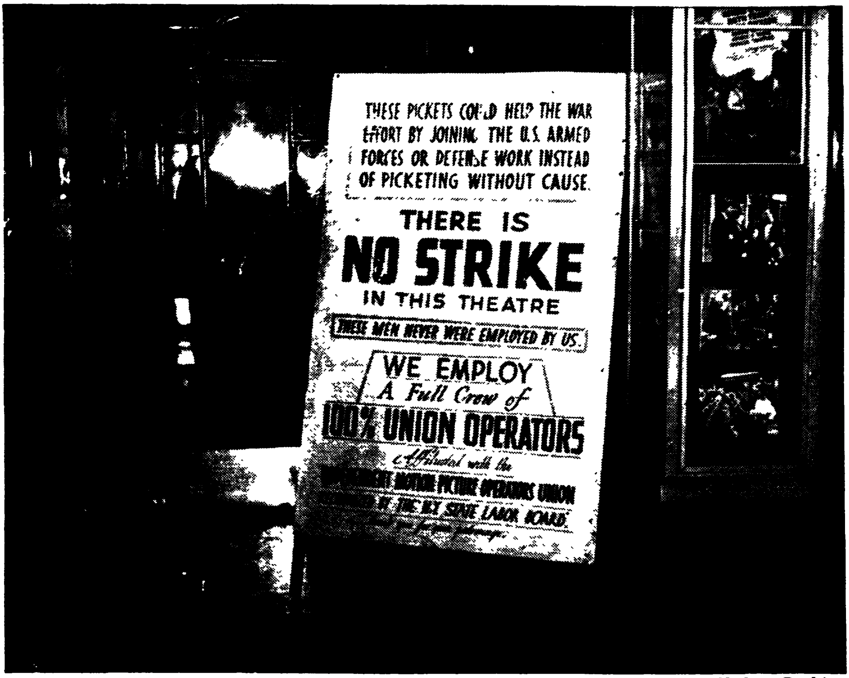
When an employer is unable to come to terms with a union, he has various ways of dealing with the situation.

*The lockout* is the employer's parallel to the strike. The employer stops production and shuts out his employees, in order to enforce his demands on the workers. A lockout is rarely necessary. Usually the employer can merely refuse to grant the workers' demands and thus leave the initiative to the union. Sometimes it is difficult to tell whether a work stoppage is a lockout or a strike. When the employer refuses to consider the union's demands or insists on his own interpretation, the workers may quit work but insist that it is a lockout, thus seeking to place the blame on the employer.

When a union makes use of its major weapon, the strike, the employer brings out his own weapons. In his attempt to keep production

going, the employer may try to get some of the regular workers to stay on the job. Also, in former years, such devices as the blacklist and espionage (now illegal) were frequently used.

Sometimes a company, particularly if it is hostile to unionism, has employed outside workers as *strikebreakers* to keep production going. Often the purpose of using them is also to discourage and intimidate the workers and to break the union. Frequently these strikebreakers have not been expected to do any work. They might be gangsters who were




*Charles Phelps Cushing*

A jurisdictional strike in process, an employer answers the pickets' signs.

intended to scare away pickets. They sometimes beat up pickets and other strikers. In the first quarter of this century, strikebreaking became a highly organized "profession." Professional strikebreaking has been made illegal by the Strikebreaker Act (Byrnes Act) of 1936.

In using violence against strikers, employers sometimes had the help of the government. Among the dark episodes in our history have been the instances of killings, injuries, kidnappings, and bombings of workers' homes and meeting halls by the Army, the National Guard, state and local police, and sheriffs' deputies. Such incidents are comparatively rare today.

There are other ways in which the employer may be able to use the

law as a weapon against the union. One such use of government aid, the *injunction*, was particularly effective until 1932. An injunction is a court order commanding a person or a group to refrain from actions considered wrong; less frequently it commands them to perform certain acts. Thus, when a union strikes in violation of a contract, an injunction may order the cancelation of the strike; labor violence may call forth an injunction to cease the violence; a union may be enjoined from organizing a group of workers.

The injunction has been a powerful weapon, because it is easy to obtain and enforce. Often an injunction has been issued by a judge on the basis of an affidavit of the employer alone, without hearing any evidence from labor. Enforcement has been easy because a violation of an injunction is an act in contempt of court. This can be considered a criminal offense and can ordinarily be tried and punished by the judge who issued the injunction, without a jury; and the penalties (fine and jail) may be very severe. Often labor injunctions have been issued on flimsy evidence and in sweeping terms. In 1934, for example, a Brooklyn judge forbade a union to continue its strike, to picket, to hold meetings near the plant, or even to mention orally or in writing that there had been a strike.

Unions campaigned bitterly against the use of the injunction. In 1932 they obtained the passage of the Norris-LaGuardia Act, which provides that "Federal courts may not prohibit workers from ceasing or refusing to work, joining a union, paying strike benefits, publicizing the facts of a labor dispute, assembling peacefully, or urging others to join or assist the strike." The procedure in issuing labor injunctions was modified so that (1) no labor injunction could be issued without giving the opposing side an opportunity to be heard; (2) in the event of a charge of violation of the injunction, the case had to be heard before a judge other than the one who had granted the injunction; (3) the defendant in a contempt action could demand a jury trial. Some states have likewise limited the issue of labor injunctions by their state courts.

### Political Activity and Propaganda

Like the unions, employers engage in political activity to strengthen their position. Lobbying is one of the chief objectives of the employers' associations, from the National Association of Manufacturers (NAM) down to the smallest local groups. They have frequently opposed wage and hour laws, social security, and laws requiring employers to bargain with unions. In political campaigns they naturally support the party and the candidates whom they consider friendly to their cause. In some instances they have tried to use pressure against their workers to in-

fluence them to vote for conservative candidates. They publish advertisements in the newspapers stating why higher wages cannot be paid, why current profits are not too high, and why a certain strike is unjustified.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| blacklist | independent union | strikebreaker |
| company union | injunction | welfare work |
| espionage | lockout | yellow-dog contract |

### II Questions and Problems

1) If you were an employer opposed to unions, what methods would you use (a) to prevent union organization? (b) to fight strikes?
2) A private detective agency, offering its services to employers some years ago, guaranteed that "there will be no strike and no disturbance." Describe the methods which could be used by this agency to prevent strikes and disturbances.
3) Describe the significance of each of these dates in labor history: 1890, 1908, 1914, 1932.
4) (a) Explain this statement: "In the company union the employer is represented on both sides of the negotiation table." (b) What arguments might the employer give in justifying his organizing a company union?
5) Is it wrong for a person to act as a strikebreaker? Discuss.
6) In parallel columns, list the labor and management methods that parallel each other. (See Lesson 66.)
7) (a) Write an editorial on the responsibilities of labor and management to each other and the public. (b) Exchange editorials and write a "letter to the editor" commenting on your classmate's viewpoint.

### III Things To Do

1) Report on the facts and the legal significance of one of the following cases: (a) Debs railway case (1895), (b) Danbury Hatters, (c) American Steel Foundries, (d) Bedford Cut Stone, (e) Hitchman Coal and Coke Co. vs. Mitchell, (f) Coppage vs. Kansas, (g) Adair vs. U.S. (For sources of information, see the readings below and at the end of lesson 69.)
2) Look up the "Mohawk Valley Formula" or "back-to-work movement" as a device for combating strike activity. A detailed account is given in *Labor Problems in American Industry* by C. R. Daugherty (Houghton Mifflin), pp. 673–675.

3) Read and report on *I Break Strikes: The Technique of Pearl L. Bergoff* by Edward Levinson (McBride), a vivid account of professional strikebreaking.

# *LESSON* 68 REGULATION OF COLLECTIVE BARGAINING

## The Public Interest in the Labor-Management Conflict

The relations between labor and management are not just their own affair. In the first place, wages and working conditions, and therefore the standard of living of millions of people, and hence the welfare of the nation, depend upon the outcome of the bargaining between labor and management. Second, if the two sides are in constant conflict, that means continual interruption of our economic activities. Production declines, and the public suffers not only inconvenience, but sometimes harm to health and safety. Third, when the two sides are bitter toward each other, they sometimes engage in violence that endangers innocent third parties, and violates our sense of law and order. Finally—and this point has only in the present generation become generally recognized—the right of workers to organize, without interference, is a fundamental economic right in a country that is proud of its freedom. All these considerations have led to a general recognition of the need for strengthening the processes of collective bargaining.

## The National Labor Relations Act (Wagner Act), 1935

With the deepening of the depression and the inauguration of the New Deal programs, the movement to improve the conditions of workers gained strength. In order to help the workers bring about self-improvement, the government decided to encourage the growth and the power of unions. First came the National Industrial Recovery Act (NIRA) of 1933 (Section 7a):

> . . . employees shall have the right to organize and bargain collectively through representatives of their own choosing, and shall be free from the interference, restraint, or coercion of employers of labor, or their agents, . . .

When the NIRA was declared unconstitutional, its labor sections were succeeded by the National Labor Relations Act (NLRA), often referred to as the "Wagner Act." The aim of the Act was clearly stated at the outset: "to promote equality of bargaining powers between employers and employees and to diminish the causes of labor disputes."

This act requires employers to bargain collectively with the repre-

sentatives of the workers. The workers decide by vote whether they wish to be represented by a union; and if there is more than one union, they choose among them. If any union secures a majority vote, it becomes the exclusive bargaining agent of all the employees. In order to make sure that these elections are fair and uncoerced, they are supervised by a government agency, the National Labor Relations Board (NLRB).

In order further to guarantee the workers' freedom of action, the NLRA designated certain specific employer activities as *unfair labor practices,* and prohibited them. It was made illegal to:

1. Interfere with or coerce employees in the exercise of collective bargaining
2. Dominate or interfere with the formation or administration of any labor organization, or contribute financial or other support to it (prohibition of company unions)
3. Encourage or discourage membership in any labor organization by discrimination in hiring or in conditions of employment
4. Discourage or otherwise discriminate against an employee for filing charges or giving testimony under the act
5. Refuse to bargain collectively with the representatives of the employees

Thus, these provisions prohibit certain antiunion activities: company unions, blacklisting, espionage, and yellow-dog contracts.

The NLRB was given power to prohibit these unfair labor practices. It can hold hearings, and if it decides that an employer has violated the law, it can issue a cease-and-desist order (see p. 323). If the employer refuses to obey, the Board can petition a federal court for an order of enforcement. Violation is then punishable by fine or imprisonment. The employer can also appeal the decisions of the NLRB to the courts.

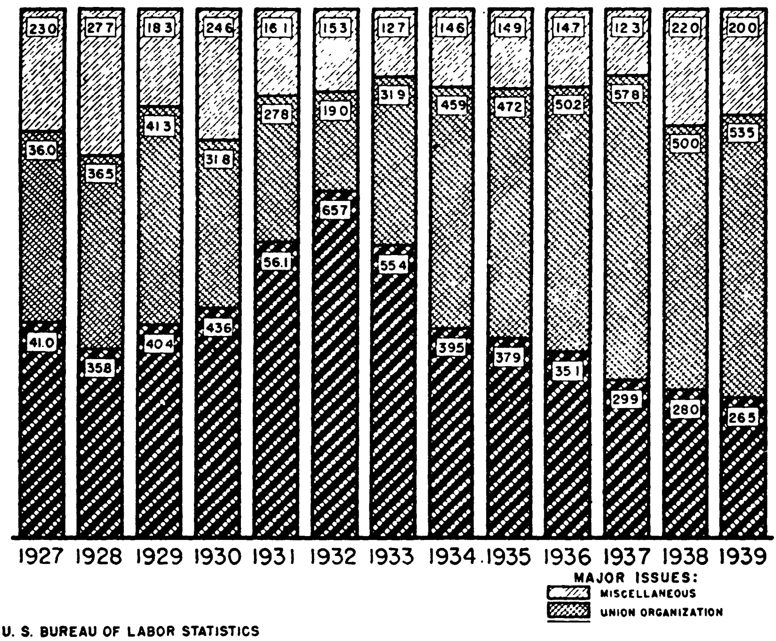
### Effects of the NLRA

"Few major transformations in the American community have occurred more rapidly than the rise of trade unions during the last fifteen years."[1] At first, employers resisted the objectives of the law. As can be seen from the chart on page 528, there was in these years a tremendous increase in the percentage of strikes whose purpose was to establish union recognition. However, largely through the operation of the law, union membership increased from nearly 3 million in 1933 to over 7 million in 1937. This included, for the first time in our history, the organization of the large masses of workers in the mass-production industries.

[1] Sumner H. Slichter, "Are We Becoming A 'Laboristic' State?" in *The New York Times,* Sunday Magazine, May 16, 1948, p. 11.

## MAJOR ISSUES INVOLVED IN STRIKES 1927-1939

PERCENT OF STRIKES




**Up to 1932 strikes frequently involved disputes about wages and hours; in 1932 almost two-thirds of all strikes centered about these issues. From 1933 to 1939 issues involving union organization grew in importance.**

As a result of these changes, the principle of collective bargaining has been firmly established. Large and strong labor unions are now a recognized American institution. The growth of union membership has increased the prestige of the labor unions in bargaining with employers. Larger membership has also meant larger financial resources, and has enabled them to carry out more effectively their various activities.

With the growth of organized labor under the NLRA came a demand from employers for government regulation of labor unions. The employers complained that the law was one-sided. In their view, it gave labor the opportunity to achieve great power, without placing adequate restrictions upon the use of that power. They pointed to the fact that the law forbade certain practices by employers but contained no corresponding list of unfair practices by labor. Some unions, they argued, had become as high-handed toward employers (and workers, too) as

some employers had previously been toward labor. No effective methods were provided under the law for dealing with violations of management-labor contracts, jurisdictional disputes, featherbedding, secondary boycotts, monopolistic practices by closed unions, and racketeering.

With the recent growth of unions, and with the improved position granted to labor by liberal legislation, there has developed the viewpoint that union power must be matched by union responsibility. To the extent that the abuses of labor are not to be removed by the action of labor itself, government regulation may become necessary. "Unions . . . cannot expect to abuse their power and still escape government regulation. . . . The labor movement is gaining too much power to hope that it can avoid permanently some degree of supervision for the common good."[2]

The traditional attitude, however, among union leaders and others has been to oppose any government regulation of union affairs. This attitude has been based chiefly upon the history of government intervention in labor disputes, which, until the 1930's, had been mainly in favor of management. They feel that their fears were realized in the passage of the Taft-Hartley Act.

### The Labor-Management Relations Act (Taft-Hartley Act), 1947

When the NLRA was finally amended by the Taft-Hartley Act, the conservative element was dominant; and the act showed it, just as the NLRA had previously shown the domination of the liberal New Dealers.

The Taft-Hartley Act modified collective-bargaining procedures in several ways. A union-shop contract was permitted only after a union-shop election was held under the supervision of the National Labor Relations Board. The union shop had to be favored by a majority of all the employees, regardless of how many voted. Only then could the employer consent to it. The closed shop was prohibited. The checkoff could be used only for union members who individually authorized the employer, in writing, to deduct their union dues. Welfare funds established with employer contributions were to be administered under specified rules, including a requirement that both labor and employers were to be represented in the board of trustees administering the fund.

Several kinds of strikes were prohibited and all others were restricted. Prohibited were sympathy strikes, jurisdictional strikes, and strikes of employees of the federal government. In all cases where a labor-management contract existed, a strike or a lockout could take place only upon sixty days' notice to the other party (the *cooling-off*

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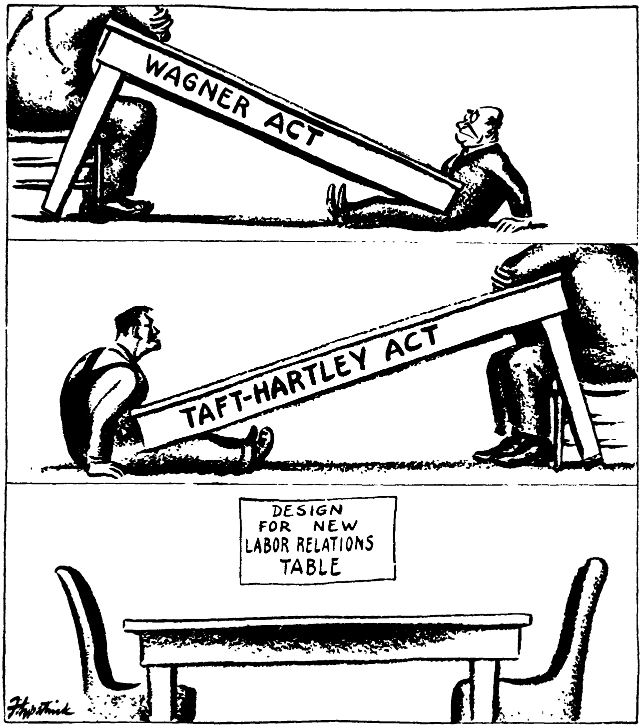
[2] Joel Seidman, *Union Rights and Union Duties,* Harcourt, Brace and Company, 1943, p. 205.

*period*), and thirty days' notice to the government. In "national-emergency" situations, the President could appoint a board of inquiry to ascertain the facts in the dispute; after the board's report, he could ask for an injunction, to remain in effect for a period up to 80 days. After a report on the situation by the board of inquiry, the NLRB was to hold a special election to determine whether the workers wished to accept




*Fitzpatrick in* The St. Louis Post-Dispatch

**This views the Taft-Hartley Act as a needed balance to the Wagner Act, which was criticised by industry as unduly favorable to labor.**

the employer's final offer. Thereafter, the strike or lockout was permissible.

The new law declared it to be an unfair labor practice for a union to

1. Refuse to bargain collectively with an employer
2. Discriminate against a nonunion worker, or cause an employer to discharge him because he is not a union member (except where there is a legal union-shop contract and the worker fails to pay his union dues)
3. Restrain or coerce a worker from exercising his right not to join a union, except where there is a legal union shop
4. Strike or boycott under the following circumstances: (a) to force an

employer to cease dealing with another employer (this prohibits the secondary boycott and the sympathy strike); (b) in a jurisdictional dispute (Note: The law, however, specifically recognized the right to refuse to cross a picket line.)

5. Impose excessive or discriminatory initation fees, where there is a union shop

6. Compel or attempt to compel an employer to pay for services not actually performed (This is aimed at some of the forms of featherbedding.)


*Herblock in* The Washington Post

**Organized labor opposed the Taft-Hartley Act, claiming it used abuses by labor as an excuse to kill effective unionism.**

The restriction in the National Labor Relations Act against employers' influencing a union election was amended by the "free-speech" provision: an employer has a right to express his views, provided that it does not go so far as coercion.

By the Taft-Hartley Act broad controls were established over union activities. Political activity of labor and management was restricted. Neither union nor corporation funds were to be used in connection with any election for federal office. Other controls were achieved by setting up two qualifications that a union had to meet in order to be able to use the NLRB, that is, in order to ask for any of the privileges

under the Act. First, the union had to file affidavits by all its officers that they were not members of the Communist Party and that they did not believe in the overthrow of the government by force or by any other illegal means. Second, the union had to file a statement giving full information about its constitution and by-laws; its elections of officers; its initiation fees and dues; fines imposed; procedure for ratification of contracts; and its annual finances. A copy of the annual financial statement also had to be sent to each member of the union.

### Evaluation of the Taft-Hartley Act

The Taft-Hartley Act has been one of the most controversial laws in our history. It was defended as necessary to restore the balance in bargaining power between labor and employers, and to remove abuses of unions toward workers and the public. Labor, on the other hand, was practically unanimous in condemning the law as unfair, a "slave-labor bill," and as hindering sound collective-bargaining relationships.

The prohibition of the closed shop was condemned by labor unions on the ground that it destroyed long-established collective-bargaining arrangements in such industries as the printing industry, building trades, and other fields. The provision that an employer in a union shop could not discharge an employee who had been dropped by the union for any other reason than nonpayment of dues was regarded as weakening union discipline. Workers might engage in wildcat strikes, in espionage, or in scabbing, yet the union could not control them through the threat of loss of jobs. The prohibition of secondary boycotts was observed with mixed feelings by labor. Some workers approved this point; but most of them claimed that it enforced "slave labor" because it was used to force workers to stay at work against their own interests.

Labor was disturbed that the law increased the opportunities for use of damage suits and injunctions against labor. It condemned the prohibition of expenditures for political purposes by unions. Although this provision seemed to treat unions and corporations equally, labor argued that employers could make large contributions to political campaigns as individuals; while individual workers could make only petty contributions. Many labor unions also condemned the anti-communist affadivits, as an infringement of political rights.

Management, on the other hand, claimed that the restrictions in the Taft-Hartley Act were merely an effort to offset the onesidedness which they saw in the Wagner Act. They defended the prohibition of the closed shop on the ground that the closed shop was a denial of job opportunities to individuals who were not union members, and was a means of establishing labor monopolies. With regard to the restrictions on labor-union activities, and the penalties permitted against unions,

they pointed out that labor, like business, was now operating on a large scale—huge memberships, multimillion-dollar treasuries, and the power to affect large areas of industry. In their opinion, large unions needed regulation as much as big business. Union members needed protection against undemocratic or dishonest labor leaders, and against the use of labor unions for political purposes not approved by the members. Several years after the passage of the Taft-Hartley Act, labor and management had not yet found a basis for agreement on legislation regarding labor-management relations.

## Exercises and Activities

### I Dictionary of Economic Terms

cooling-off period unfair labor practice

### II Questions and Problems

1) State four reasons why the public is interested in the peaceful settlement of labor-management disputes.
2) (a) Why is it in the public interest "to promote equality of bargaining powers between employers and employees," and "to diminish the cause of labor disputes"? (b) To what extent were these goals achieved through the Wagner Act and the Taft-Hartley Act?
3) Explain how the NIRA laid the groundwork for the NLRA.
4) (a) What anti-union activities are prohibited by the Wagner Act? (b) What union activities are prohibited by the Taft-Hartley Act?
5) The Wagner Act has been criticized as giving labor too much power. Discuss this charge from the viewpoint of (a) labor, (b) management.
6) The Taft-Hartley Act has been criticized as being too severe toward labor. (a) Explain the provisions in the law which have been the basis for making this criticism. (b) Explain the arguments which have been given in defense of these provisions.
7) If you were writing a new labor-management act, which provisions of the Wagner and Taft-Hartley Acts would you retain? Why?

### III Things To Do

1) Arrange a class dramatization of a hearing before the NLRB on an "unfair labor practice" charge (a) against an employer, (b) against a union.
2) Arrange a student symposium on "A Fair Labor-Management Law." The following viewpoints might be represented: (a) restoration of the original NLRA, (b) retention of the Taft-Hartley Act, (c) a compromise between those two Acts, (d) a new approach to labor peace.

3) Arrange for outside speakers representing labor and management to address your class, a school club or an assembly on "A Fair Labor-Management Law."

## LESSON 69 DEVELOPMENT OF THE AMERICAN LABOR MOVEMENT

### Early Attempts at Unionization

The first American labor unions were organized by carpenters and by shoemakers in Philadelphia in the 1790's, but it took almost another century for American workers to become organized on a permanent basis. Many craft unions were established in the first half of the 19th century; but whenever a serious depression occurred, they were crushed by the lack of jobs, loss of membership, and the consequent lack of union funds.

Although the early unions individually did not last long, as a group they had a positive influence upon American history. They made the American public conscious of the demands which organized labor was then making—the ten-hour day, free public schools, abolition of imprisonment for debt, restrictions on child labor, control of monopolies, and income taxes.

The War Between the States, the Industrial Revolution, and the post-war boom created the conditions for rapid development of labor unions. More and more, large groups of workers were concentrated together in huge factories and were therefore better able to organize. More and more, they realized that they would have to seek self-improvement through unionization.

In the second half of the 19th century hundreds of new locals and more than thirty national unions were formed. Some of these unions are still in existence.

These organizational steps were taken in the face of a hostile attitude by employers. Discipline in the factories was very tight, and unionization was generally prohibited.

### The Knights of Labor

The first national federation of American workers that succeeded in attaining fairly large membership and a relatively long existence was the Knights of Labor, founded in 1869. The Noble Order of the Knights of Labor was not a labor organization in the present-day sense. It was established as one big union, including all kinds of workers without

separating them by trade or industries; in many local branches workers from different industries were mixed together. It even had farmers and business and professional men as members.

Because of fear of blacklists, the Knights of Labor operated for the first ten years as a secret organization, but in the 1880's it came out into the open. Under the leadership of Uriah S. Stephens, and then of Terence V. Powderly, its membership reached a peak of 700,000 in 1886.

The newly organized workers at first lost many battles because of the powerful opposition of their employers, but later won some spectacular strike victories. However, this success was short-lived. The reputation of the Knights of Labor was lessened by a series of unsuccessful strikes. The organization was a collection of many loose parts, and was hard to hold together. The Haymarket Riot of 1886, in which some Chicago policemen were killed by a bomb, made it easy to pin the label of "anarchism" on the entire labor movement. By 1890 the membership of the Knights of Labor had dropped to 100,000 and it had become an insignificant organization. However, the experience of this organization paved the way for the later success of the American Federation of Labor.

### The Rise of the AFL

The American Federation of Labor was founded in 1886 by a group of craft unions, of which the most important were the cigar makers, carpenters, printers, and iron and steel workers. From 1886 to 1924 its president was Samuel Gompers, who was succeeded by William Green. Starting with a membership of 138,000 in 1886, it had over 1,500,000 in 1904; over 4,000,000 in 1920; and more than 7,000,000 in 1949.

The success of the AFL was largely due to its structure and its policies. It was not organized as a single union, but as a federation of unions. Each union was a closely knit organization of workers, such as carpenters, with a common interest in a particular field. At the same time it could coöperate with all the other unions, through the AFL, in pushing the interests of labor in general.

Another important change was the AFL's policy of *business unionism* instead of *political unionism*. The AFL leaders believed that the Knights of Labor had made a mistake in becoming involved in politics —running their own candidates for Congress and state legislatures, and making alliances with political groups. Moreover, in their opinion, it was not the function of trade unions to change the capitalistic system into socialism or any other system. They would get further by accepting the capitalistic system, and fighting to get for the workers, here and now, better working and living conditions. Instead of organizing its own

political party, or affiliating itself with any party, the AFL has supported candidates of either major party who proved themselves friendly to labor, and has opposed candidates unfriendly to labor, regardless of their party labels.

Not all labor leaders agreed with this policy. When the AFL refused to abandon its policy of business unionism, the more radical leaders organized rival labor organizations such as the Industrial Workers of the World (IWW) and the Trade Union Unity League. These radical union groups did not build up large followings, but they divided the ranks of organized labor.

A much more serious problem, however, was the systematic opposition of employers. In 1895, the National Association of Manufacturers was organized, and later many other employers' associations were formed. These business groups refused to recognize the right of labor to unionize. Open-shop drives, yellow-dog contracts, blacklists, and spies were used to keep workers from joining unions.

Particularly discouraging to labor unions was the aid given by the government to the employers. Police and militia protected the rights of the employers more effectively than the rights of the workers. The courts interpreted the antitrust laws so as to limit the activities of labor unions. In the name of law and order, labor leaders were jailed and strikes were crushed.

In view of these obstacles, the accomplishments of the American Federation of Labor were notable. Through collective bargaining and through legislation, the AFL and its affiliated unions achieved much for the workers and for the general public.

### The Decline of Organized Labor, 1920–1933

During the period from 1920 to 1933, the American labor movement seemed to be breaking down. After World War I, there were a series of unsuccessful strikes. The depression of 1921–1923 caused many members to drop out of the unions. The employers' associations renewed their campaigns to check the growth of the labor movement. The slogan "The American Plan" was used by them to spread the feeling that their open-shop campaign was protecting the American people from alien ideas. The Communist Revolution in Russia in 1917 made it easy to develop "red scares" in this country, and to justify the suppression of the civil rights of union members.

During the second half of the 1920's many American firms adopted the policy of winning their workers away from the ranks of organized labor. Company unions were organized and were presented to the workers as "industrial democracy." Wage increases were given. Many firms encouraged their employees to buy shares of stock and thus be-

come "partners" as well as employees. "Welfare capitalism" was thus developed to a high degree. Books and pamphlets were written to emphasize the idea that labor and management are partners in the sharing of the national wealth. Millions of American workers began to feel that they no longer needed an organized labor movement.

A contributory factor in this decline of organized labor was the weakness within the labor movement. The AFL was criticized on the ground that many union heads no longer acted as aggressive leaders, but rather as mediators between the employers and the workers. It was also criticized because, until the depression of the 1930's, it opposed proposals for minimum-wage and social-security laws as leading to government regulation of labor. Radical groups fought to win the workers away from the AFL leadership This division in the ranks of organized labor was a factor in the loss of some crucial strikes. It also made many workers, and the public in general, antagonistic to the labor movement. Doubtless the abuses of labor unions—jurisdictional disputes, racketeering in some unions, labor violence—contributed toward this antagonism.

The depression of 1930–1933 almost sealed the doom of labor. Unemployment was so great that the unions could do little to resist the slashing of wages, the increased use of substandard labor, and the spread of the open shop.

### The Emergence of the CIO

As the business world recovered from the depression, unionism also recovered. By 1936, the AFL membership was as large as it had been in 1920. Because of the terrible conditions of the early 1930's, labor had won the sympathy of the government and of the public. New Deal laws established legal recognition of collective bargaining, minimum wages, and social insurance.

Despite this progress, there was dissatisfaction within the AFL. Some of its leaders felt that the craft basis of the AFL was out-of-date. Mass production had grown to such a degree that the large majority of American workers were now semiskilled and unskilled. But the AFL had made little attempt to organize the mass-production workers in steel, automobiles, rubber, electrical appliances, and other fields.

Since the unorganized workers were mainly semiskilled and unskilled, they could not easily be fitted into the craft unions of the AFL. However, there were some industrial unions in the AFL, and it was the leaders of these unions who urged the AFL to organize more industrial unions. Among them were John L. Lewis of the United Mine Workers, and Sidney Hillman of the Amalgamated Clothing Workers. The AFL was dominated, however, by the craft-union leaders, who

were not interested in undertaking such a difficult and costly project. Besides, there was still a feeling among some that the craft union was the superior type of organization, since the workers in a limited field were more closely tied to each other by mutual interests, similar skills, and identical standards, unlike the great variety found in an industrial union.

In 1936, finally, the industrial-union minority of the AFL set up the Committee for Industrial Organization. They contributed organizers and money. When the AFL expelled these unions, in 1937, for having


Labor Information Bulletin, *November, 1948*

*Growth of American Labor Union Membership.* For twenty years, up to 1920, union membership steadily increased. From 1920 to 1925 it declined. The greatest growth came after the passage of the National Labor Relations Act in 1935. By 1948 membership had expanded to about four times the level in 1935.

taken this "splitting" action, the CIO was changed into a permanent organization, a new federation of labor—the Congress of Industrial Organizations.

The success of the CIO was phenomenal despite the opposition of employers. It made effective use of mass picketing, sit-down strikes (until these were declared illegal), and spectacular propaganda, to capture the imagination of the workers and the public. The ten unions which had started the CIO had had about a million members. In 1937, the CIO unions, old and new, had over 3,000,000 members; and in 1950 they had about 6,000,000. The first president of the CIO was John L. Lewis, and he was succeeded in 1940 by Philip Murray.

The rise of the CIO stung the AFL into action. New industrial unions

were organized as rivals of the CIO unions. By 1950 about one-third of the organizable workers of the country were enrolled in labor unions; in the manufacturing industries, about half.

The rivalry of the two federations caused numerous jurisdictional disputes, the kind of labor dispute which most easily antagonizes public opinion. Because of the boom conditions of the 1940's, this competition did not do any serious harm to the labor movement in that period. In a depression period, however, employers might play one federation against the other, and thereby weaken labor's position. In lobbying, public-relations work, and international conferences, American labor is unable to present a united front, and therefore has less influence than it might have.

Achieving unity is not easy. In labor, as in business, there are vested interests. A labor leader may have given his years and his energies to building up his own organization. He may have become accustomed to being the leader, he enjoys the prestige, and, in many cases, he gets a reasonably good salary. There is the danger that a merger with a rival union will bring new elements into the organization and weaken his control. There are also many complex problems of jurisdiction which it might take years to work out. The AFL and the CIO also differ in their political strategy. The AFL still largely follows the policy of political neutrality as between the Republicans and the Democrats. The CIO from its beginning has allied itself with the New Deal group in the Democratic Party, and has supported that party as the pro-labor party. The sentiment for a separate labor party is much stronger in the CIO than in the AFL.

There are many who believe that a unified labor movement would not only strengthen the unions but would bring greater stability and harmony in the relations between labor and management. The hope for this unity has been stimulated by the many instances of coöperation between CIO and AFL unions in political and other activities.

### Exercises and Activities

I Dictionary of Economic Terms

| | |
|---|---|
| business unionism | political unionism |

II Questions and Problems

1) What conditions after the War Between the States led to the strengthening of labor unions?
2) Compare the Knights of Labor, the AFL, and the CIO as to structure and policies.

3) What have been the major obstacles to the growth of labor unions?
4) (a) What is the difference between business unionism and political unionism? (b) Describe, with examples, the growth of political activities in the labor movement.
5) "The success of the AFL resulted from the fact that it made unionism a business rather than a revolutionary movement." (a) Explain this statement. (b) In what ways did this change further the progress of the American labor movement? (c) What weaknesses did this change eventually produce?
6) (a) What were the factors which led to the establishment of the CIO in the 1930's? (b) How did the establishment of the CIO affect the growth of the AFL? (c) Why has it been difficult for the AFL and CIO to unite?
7) How does the American labor movement now compare with the American labor movement after World War I? Explain the reasons for the similarities or differences.
8) What are some of the reasons why the labor movement has been less radical in the United States than in Europe?

## III Things To Do

1) Compare the history of the American labor movement with that of Great Britain. Consider such factors as workers' attitudes, employers' attitudes, government attitude, proportion of workers organized, political activities.
2) Write a report on one of the major labor leaders. Biographies have been written on Gompers, Powderly, Debs, John Mitchell, and John L. Lewis. *American Labor Leaders* by Charles A. Madison (Harper, 1950) is a recent study of labor leaders.
3) Read and report on (a) *Labor in America,* Revised, by Harold U. Faulkner and Mark Starr (Harper, 1949). (b) *The American Story of Industrial and Labor Relations* (New York State Joint Legislative Committee on Industrial and Labor Conditions, 1943). In a simple treatment, this study traces the parallel development of the American economy and of labor-management relations.

# *UNIT* 12

## INTERNATIONAL ECONOMIC RELATIONS

*70* INTERNATIONAL PROBLEMS OF RESOURCE USE

*71* INTERNATIONAL TRADE RELATIONSHIPS

*72* PAYMENTS IN INTERNATIONAL TRADE

*73* FOREIGN EXCHANGE

*74* BARRIERS TO WORLD TRADE

*75* STABILIZING WORLD TRADE

# LESSON 70 INTERNATIONAL PROBLEMS OF RESOURCE USE

## Political Boundaries and Resource Use

A newspaper once published an advertisement which featured a picture of a typical American family in a typical American living room. The headline read, "This American living room comes from thirty different countries!" The lady's perfume came from France, the diamond in her ring from South Africa, the crocodile leather of her shoes from Mexico or India. The desk was made of mahogany from Honduras, cross-banded with satinwood from Ceylon; standing on the desk was an inkwell of English silver, and the ink contained gallic acid from China, Syria, or Turkey. The paint on the walls contained linseed oil from Argentina, castor oil from Brazil, tung oil from China, pigment from Belgium, Spain, or France, and natural resins from all over the world. The telephone on the table contained eighteen materials from foreign countries. But it would take too long to complete this analysis.

Had the title of the above advertisement been, "This living room comes from 30 different states," it would have attracted little attenion. But the average American still is not certain as to whether it is good or bad that his standard of living depends so much upon the rest of the world. He has no difficulty in thinking about the United States of America as an economic unit. But suppose there were no U.S.A.—merely forty-eight independent nations, suspicious and afraid of one another. Would the people of Minnesota feel it wise to export all their iron ore to steel mills in Illinois, Ohio, and other nearby "countries," or would they feel it necessary to create their own steel industry? Could Iowa afford to devote itself so much to raising corn or hogs, or would it have to develop strategic industries for possible use in war? Would Massachusetts and Rhode Island allow the importation of textiles from the lower-wage mills of South Carolina and Georgia? Would the dairy farmers of New York demand tariff protection from the competition of dairy farmers of other states?

To the geographer, political boundaries are a handicap. When he looks at the map of Europe, he sees a great plain stretching from the center of France through Belgium, Holland, northern Germany, and Poland, into the central part of the Soviet Union. He regards as a single industrial region the coal mines of the Ruhr valley and Eastern Belgium, and the iron mines of Lorraine. From his viewpoint, it is wrong

that the waterfalls of the Italian mountains should be separated from the French valleys which need hydroelectric power.

For the geographer the basic fact is that nature created but one world, in which it distributed fertile land and minerals in a variety of quantities and qualities. By means of migrations, wars, and treaties, man has superimposed upon nature's "one world" many different political divisions, with only casual regard for the natural geographic divisions. These political divisions have created the problems of international trade.

### Factors Influencing Geographic Specialization

International trade is an extension of domestic trade to a wider area. Businessmen prefer to buy goods wherever they can get the best values, considering price and quality. For some parts of New England it is cheaper to use coal shipped by water from Nova Scotia in Canada, than coal shipped by rail from Pennsylvania. Businessmen also search for markets wherever possible. American textile manufacturers compete with those of Germany, Great Britain, and Japan for business in Latin America and Asia.

The growth of trade between one area and another has been furthered by *geographic specialization* (or *geographic division of labor,* or *localization of industries*). This means the tendency of an area to specialize in producing those goods and services from which it can make the largest amount of profit. Specialization is, however, a relative term; it does not mean that a region devotes itself exclusively to one product. The cotton country of the South also raises corn, hogs, peanuts, and other products. Brazil is known for its coffee, but it also grows cotton, raises cattle, and manufactures steel.

Geographic specialization takes place mainly because of the uneven distribution of natural resources throughout the world. Our South has been the greatest cotton-growing region of the world, because it has the proper combination of soil, rainfall, and growing season. The highlands of Brazil have the physical conditions suitable for the growing of coffee beans. The Mesabi Range in Minnesota has rich deposits of high-quality iron ore close to the surface, and is conveniently located for cheap transportation.

Another important factor is the development of specialized skills, often over many centuries. This accounts for the Wedgwood dishes made in England, Jensen silver jewelry in Denmark, champagne and silk gloves in France, painted screens in Japan, and fine glassware in Czechoslovakia. In this country, New England prides itself on its large supply of skilled labor, with which it turns out superior grades of hardware, textiles, paper, tools and dies, and watches.

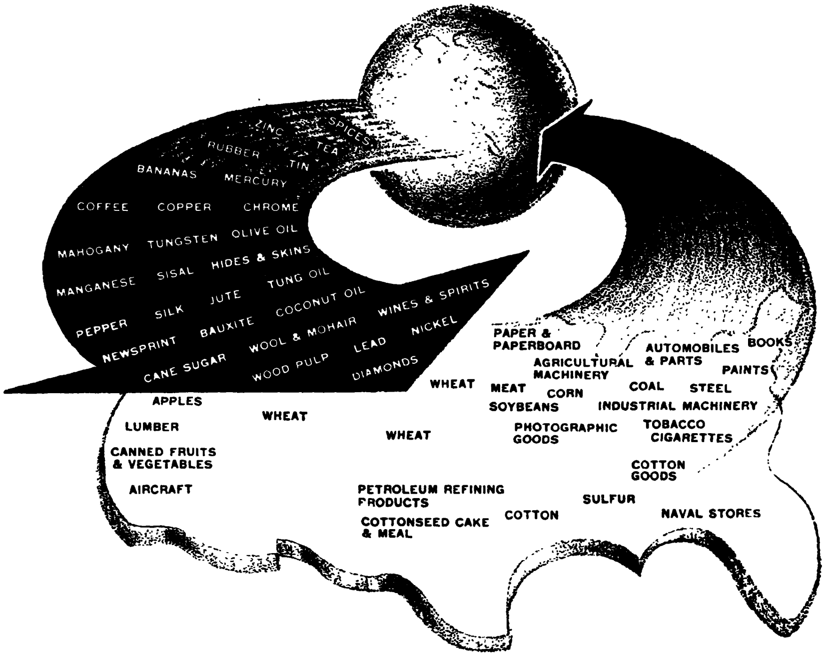
Numerous other factors contribute to geographic specialization. The northern parts of Ohio, Indiana, and Illinois, along the Great Lakes, have become the chief steel-producing center of this country, because this area is located between the coal mines of Pennsylvania, West Virginia, Ohio, and Kentucky, and the Mesabi iron mines; and because the Middle West is a big market for farm machines. The region near Niagara Falls is a good place for industries needing cheap electric power, as does the aluminum industry, for example. The farmers in New England, New York, New Jersey, Michigan, Wisconsin, and other industrialized regions have found it profitable to become dairy and vegetable farmers because the many nearby cities furnish a ready market for these products.

Each part of the world has tended to specialize because it is usually more profitable to specialize than to try to be self-sufficient. This is true for the individual; it is also true for a city, region, nation, or continent. For the world as a whole, the value of specialization is that goods are produced in large amounts at the lowest possible cost. This can be done because production is carried on by those workers, with those materials, and in those places best fitted for the production of that particular product. It would be possible to produce silk in the United States; but it requires a great deal of hand labor. It is therefore cheaper for American businessmen to buy silk from Japan, where labor is much cheaper. American manufacturers concentrate on producing automobiles, machinery, and other goods which they can produce most cheaply because of superior technology, despite the higher cost of American labor. Latin-American countries could produce their own machinery; but it is economical for them to buy machinery from other countries, and to specialize in the production of raw materials and foods.

The wider the area in which specialization is practiced, the greater the benefits. This is one of the main reasons for the extraordinary economic development of the United States. The United States Constitution places control of interstate commerce in the federal government. American businessmen therefore have a large domestic market of about 150,000,000 people, with no tariffs on interstate commerce. Each region of the United States has devoted itself mainly to those economic activities for which it is best fitted by its resources, location, and manpower.

To a lesser extent this has been true of the world as a whole. Despite political boundaries and tariff walls, the profitableness of world trade has stimulated geographic specialization throughout the world. The iron ores of Lorraine have been used by the steel mills of both Germany and France, regardless of whether Lorraine belonged to Germany or to

## FOREIGN TRADE IS VITAL TO ALL PARTS OF THE U.S.




The black print on the map states some important exports and where they are produced; the white print on the arrow shows some of our chief imports.

France. The oil of Venezuela, the rubber and tin of Malaya, and the cotton of the United States, have normally been available to buyers in all parts of the world.

### The Danger of Geographic Specialization

Geographic specialization depends on two assumptions: (1) that there will always be an adequate market for the large supply made possible by specialization, and (2) that the goods not produced in one place will always be available from another place in adequate amounts and at reasonable prices. The danger of making the first of these assumptions is illustrated by the experience of the South. For a century "King Cotton" brought great wealth to the South. By the 1930's, however, the cotton farmers found that the demand for their cotton was declining because of larger cotton production in other parts of the world and because of the increasing use of rayon. Specialization thus may become a boomerang. At first it brings great wealth. Later it

makes the continuation of that wealth dependent largely on the continuation of good prices for a single product or a limited number of products.

Realizing this fact, Southern farmers have gradually moved away from specialization. With the aid of government experts, they have diversified their crops. More and more capital is being invested in the development of Southern manufacturing industries—textiles, paper, rubber tires, steel, and others.

Other parts of the world, too, have discovered the dangers of specialization. During the 1930's, Argentina found that the market for its wheat, meats, and hides was shrinking; and Brazil was faced with overproduction of coffee. The manufacturers of Great Britain found it increasingly difficult to meet the competition of American, German, and Japanese manufacturers in the markets of Latin America, Asia, and Europe. The decline in income forced these countries to reduce their imports. They had to begin to produce at home some of the goods they had been accustomed to buying abroad—or do without. Thus began a trend away from specialization and economic interdependence toward diversification and economic independence.

The danger of the second assumption about specialization—the availability of goods—is most apparent in wartime. In the 1930's, the possibility of war was so great that nations generally desired self-sufficiency. The outstanding examples were Germany and Italy. They encouraged the growth of population in order to have an ample supply of labor. Their scientists worked overtime to develop *ersatz* materials; synthetic substitutes for materials which they previously had purchased abroad. Rubber and gasoline, for example, were produced from coal, and synthetic foodstuffs from waste materials. Special subsidies were paid by the government to exporters, so that they could get rid of surplus goods in foreign markets; these exports would supply funds with which to import materials needed for production. The importation of luxuries and other goods not vital to the country's industries was cut down. In view of the costs involved, as well as the deprivations, the effect was a lowering of the standard of living of the people in order to gain a greater degree of self-sufficiency.

*Autarchy* is a policy whereby a nation strives to be completely self-sufficient within the area which it controls. The emphasis on self-sufficiency is part of the growth of a spirit of *nationalism*, and is in contradiction to the spirit of *internationalism*. The nationalist wants his nation to be economically independent of the rest of the world. The internationalist views the nations of the world as interdependent, sharing the resources of the world for their mutual benefit.

IMPERIALISM

Another way for a nation to achieve self-sufficiency has been followed through the ages—*imperialism*. Imperialism is the attempt by a nation to expand its area of control. This may be accomplished through such methods as conquest and annexation, settlement in uninhabited areas, or establishment of *spheres of influence.* A sphere of influence is an area (a whole nation, a part of a nation, or a group of nations) in which the political and economic activities are controlled by an outside nation. Since there are few uninhabited areas left in the world, and conquest is difficult and costly, the establishment of a sphere of influence is now perhaps the most important method of achieving imperialistic control.

We have had numerous examples of spheres of influence. From the middle of the nineteenth century to the 1930's, the Yangtse valley of China was regarded as a British sphere of influence. The Caribbean area is considered our country's sphere of influence. The "satellites" of the Soviet Union are a Soviet sphere of influence, while much of the Near East is a British sphere of influence.

There are varying degrees of control over the sphere of influence. The controlling power may dictate who shall hold office, and what domestic and international policies shall be followed. In some cases the outside power does not interfere in the political life of the sphere of influence; it merely makes sure that favorable conditions are created for the economic advancement of the controlling power and its citizens. Arrangements are made for the development of the natural resources and industries of the sphere of influence, with capital invested by the outside power, or by citizens of the outside power. Special trade and tariff arrangements are made, which enable the businessmen of the outside power to undersell the businessmen of other nations, or to monopolize the market, in the sphere of influence. Loans may be made to the "dependent" power by the outside power, which can then use its position of creditor as a means of bringing pressure upon the sphere of influence.

Undoubtedly imperialistic expansion has speeded up the world's industrial and commercial progress. The farm lands, the mines, and the jungles in all parts of the world have been brought rapidly into use, because imperialistic control created profit-making opportunities for the businessmen of the imperialistic countries. Along with economic progress have come improvements in communication and transportation, education, sanitation, and government.

There are grave doubts, nevertheless, about the value of imperialism. The cost of conquering and controlling areas has, over the centuries, been stupendous. It is hard to say whether the imperialistic nations

have gained enough financially for their people as a whole to compensate for the cost of providing profits for their businessmen. It is argued that the "backward areas" would eventually have been developed without the costly methods of imperialism—more slowly, but inevitably. Although imperialism has brought progress to the backward areas of the world, the people of those areas have not shared in this progress equally with the people of the imperialist nations. Native labor—labor supplied by the natives in controlled areas—has been used as cheap labor, to enrich those who have obtained control of the resources of the backward areas. Perhaps the most important charge made against imperialism is that it has been the chief reason for wars.

In 1941, the world accepted the Atlantic Charter as an expression of hope that a new path might be found to peace and security. One of the promises in the Charter was that the signers "will endeavor, with due respect for their existing obligations, to further the enjoyment by all states, great or small, victor or vanquished, of access, on equal terms, to the trade and to the raw materials of the world which are needed for their economic prosperity."

## Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

| | |
|---|---|
| autarchy | imperialism |
| geographic specialization | sphere of influence |

II QUESTIONS AND PROBLEMS

1) Explain how geographic specialization is the result of natural and human differences. Give some examples.
2) (a) What are some of the benefits of geographic specialization? (b) What problems are created by geographic specialization?
3) In what ways has the United States offered examples of both the benefits and the dangers of geographic specialization?
4) Match the following places with their specialties (refer to a geography textbook if you need help):

| PLACE | SPECIALTY |
|---|---|
| Amsterdam (Netherlands) | watches |
| Chicago | cheap shoes |
| Malaya | meat packing |
| Czechoslovakia | tin |
| New York City | clothing manufacture |
| Niagara Falls | diamond cutting |
| Gulf Coast | aluminum goods |
| Switzerland | semitropical fruit |
| Great Britain | rice growing |
| California | shipbuilding |

5) (a) What economic benefits would develop if all North America were under one government? (b) What are the barriers to this economic unity?
6) (a) Why have nations emphasized self-sufficiency? (b) How has the world been affected by the attempts to achieve self-sufficiency?
7) Mankind has divided nature's "one world" into dozens of nations. (a) What have been the benefits of dividing the world into many nations? (b) What have been the disadvantages?
8) (a) Describe and illustrate the benefits of imperialism. (b) Describe and illustrate the evils of imperialism. (c) Which do you think have been greater—the benefits or the evils?

III THINGS TO DO

1) Make a check list of how one day in your life is affected by international trade.
2) Write a brief essay comparing autarchy in the 20th century with mercantilism in the 18th century.
3) Write an essay on the question, "Is imperialism coming to an end"? Give evidence for your opinion.

# LESSON 71 INTERNATIONAL TRADE RELATIONSHIPS

## VISIBLE AND INVISIBLE EXPORTS AND IMPORTS

One of the reasons that the people of Switzerland have been well-to-do has been their ability to "export the Alps" to all parts of the world. The Alps are still where they always have been. But, over many generations, millions of people have paid billions of dollars to Swiss railroads, inns, and stores in order to enjoy the scenery, mountain-climbing, and winter sports in the Alps. These tourist expenditures, like foreigners' purchases of their watches and chocolates, have enriched the Swiss people.

When Americans buy the services of other countries for business trips and vacations, they are "importing." Payments flow from the United States to these other countries in the same way as when businessmen in this country buy merchandise from these countries. When foreigners buy services from this country, we are "exporting." Payments flow into this country in the same way as when American merchandise is sold to other countries.

An *export* is any transaction which entitles someone in the exporting country to a payment from someone in another country. An *import* is any transaction which requires a payment by someone in the importing

country to someone in another country. Obviously, all American imports are the exports of people in other countries, and all American exports are the imports of people in other countries. *Visible exports* and *visible imports* are sales and purchases, respectively, of goods. *Invisible exports* and *invisible imports* are sales and purchases, respectively, of services.

The following table shows the chief kinds of visible and invisible exports and imports. It lists the items from the viewpoint of this country. This table is called the *balance of payments,* because it is a list of the various items which cause payments to flow in and out of this country. The expression *balance of trade* is used to compare only visible exports and visible imports. A *favorable balance of trade* means that visible exports are greater than visible imports. The words "favorable" and "unfavorable" do not mean "good" and "bad"; they merely show the proportions of visible exports and imports to each other. The use of these terms originated in the days when a favorable balance of trade was considered necessary to the welfare of a country.

Balance of International Payments of the United States

| *Exports (Payments In)* | *Imports (Payments Out)* |
|---|---|
| VISIBLE | VISIBLE |
| Sales of merchandise to people in other countries | Purchases of merchandise from people in other countries |
| INVISIBLE | INVISIBLE |
| Expenditures of foreign travelers in the United States | Expenditures of Americans traveling in other countries |
| Payments from foreign countries to American firms for shipping, insurance, banking services, use of patents and copyrights, etc. | Payments to foreign companies for shipping, insurance, banking services, use of patents and copyrights, etc. |
| Investments by foreigners in American businesses or in securities of American governments | Investments by Americans in foreign businesses or in securities of foreign governments |
| Interest and dividend payments to Americans by foreign corporations and governments | Interest and dividend payments by American firms to foreign investors |
| | Loans by the American government to foreign countries |
| | Remittances by Americans to relatives and charitable causes in foreign countries |

In all countries the visible exports and imports constitute the major part of the balance of payments. But for some countries the invisible items are also important. The income from the shipping industry has been important to countries like Great Britain, France, Norway, Germany, and Japan. During the 19th and 20th centuries, the wealthy citizens and corporations of Great Britain, France, Germany, Holland, the United States, and other countries made investments in businesses and government bonds in all parts of the world. The dividends and interest received on these investments increased the national incomes of the investors' countries.

The significance of invisible items in international trade is no different from their significance in domestic trade. A large proportion of the people in any country make their living by selling services rather than goods—for example, professional people and those working in insurance companies, banks, transportation companies, and hotels. Some regions and cities in this country receive a very important part of their income from tourist expenditures—Florida, California, New England, and New York City, for example. As far as the standard of living is concerned, it does not matter whether income is derived from selling goods or selling services, from domestic trade or from foreign trade.

### The Importance of Foreign Trade to the United States

Suppose it became necessary for the United States to shut itself off completely from the rest of the world—what would be the effect on profits, employment, and standards of living in this country?

It should be noted, first, that this country's foreign trade (exports and imports) constitutes only about 10 percent of its total business. It would seem that the United States could get along without this seemingly small amount of foreign trade. This 10 percent is, however, an average, which hides important facts about specific industries. The figures in the table on page 553 show, by a few examples, how important some exports have been to the American people. For example, the prosperity of the entire South is dependent on the exports of cotton.

The table shows that a closing of foreign markets to American exports might have disastrous effects on the American business system—unless the domestic market could be enlarged sufficiently to absorb all the products which are now sold abroad.

The United States is dependent on foreign countries also for imports. Elimination of imports would deprive American business of tin, nickel, manganese, and other raw materials which are indispensable for our manufacturing industries. It would also deprive American consumers of some of the comforts and luxuries which have become part of their

standard of living. Any effort to develop here the handicraft industries of other parts of the world would be hindered by the higher cost of American labor. At the same time, giving up export markets would reduce the volume of sales for many American industries, and would therefore tend to increase their overhead cost per unit. Self-sufficiency is apparently possible only with a lower standard of living.

PERCENTAGE OF PRODUCTION EXPORTED*

| *Raw Materials* | *Percent Exported* | *Manufactures* | *Percent Exported* |
|---|---|---|---|
| Cotton | 44 | Patent leather | 69 |
| Leaf tobacco | 36 | Linseed oil | 44 |
| Copper | 33 | Electrical apparatus | 32 |
| Sulphur | 28 | Lubricating oil | 31 |
| | | Aircraft and parts | 27 |
| | | Office machinery | 23 |
| *Foodstuffs* | *Percent Exported* | Mining machinery | 19 |
| Prunes | 42 | Radio apparatus | 12 |
| Canned fruit salad | 35 | Automobiles | 8 |
| Canned sardines | 29 | | |

* Adapted from data of U.S. Department of Commerce for 1935–1937.

Invisible exports and imports also mean much to the United States. For example, at the beginning of 1948, American citizens had nearly 17 billion dollars invested in foreign countries, and the United States government had about 12 billion dollars invested in foreign countries and international agencies. Foreign governments and individuals had investments amounting to over 16 billion dollars in this country.

American self-sufficiency would also have a serious effect on the rest of the world. The United States now is the key country in the economic system of the world. Even before World War II, the United States was producing over one-fourth of all the goods produced in the world, and the proportion in 1950 was probably one-third.[1] The United States is now the leading exporter of merchandise; this means that the rest of the world depends on this country for these goods. The American people are also, with the possible exception of the British, the leading importers of merchandise; the rest of the world depends on the United States as a market for a large proportion of their goods.

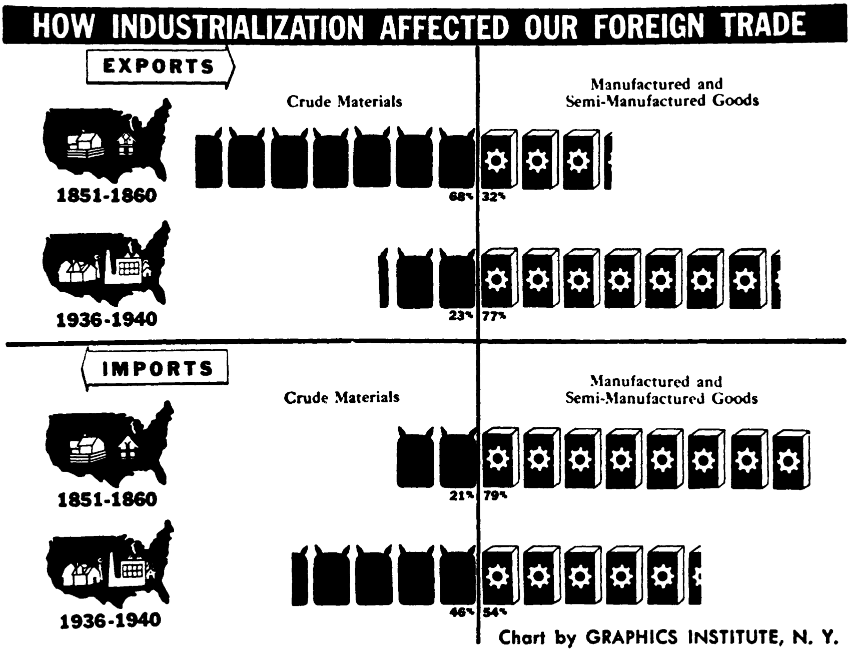
## CHANGING TRENDS IN AMERICAN FOREIGN TRADE

The position of the United States in the economic system of the world has changed greatly during the past half-century. Our exports of food-

[1] Twentieth Century Fund, *America's Needs and Resources,* 1947, p. 512.

stuffs and raw materials are larger in amount, but they constitute a smaller percentage of our total exports than at the beginning of this century. The leading exports are machinery, cotton and cotton manufactures, petroleum and petroleum products, automobiles and automobile parts, iron and steel products, tobacco, and fruits and nuts.

As a result of the expansion of its manufacturing industries, the United States imports mainly raw materials, semi-finished goods, and foodstuffs. Manufactured goods comprise only about one-fifth of our




In the ten years prior to the War Between the States, crude materials made up 68% of exports, and manufactures 32%. On the other hand, only 21% of imports were crude materials, while 79% were manufactured. In the five-year period before our entry into World War II, the picture was different; 77% of exports were manufactured goods, and almost half of all imports were crude materials.

total imports. The leading imports are wood and paper products, rubber, sugar, coffee, wool and cotton products, hides and furs, copper and tin, raw silk, and vegetable oils and fats.

The changes which have occurred in our exports and imports over the past hundred years are shown in the graph above.

A change has also taken place in the direction of American foreign trade. A hundred years ago two-thirds of our exports went to Europe, and about the same proportion of our imports came from that continent.

Now, with the change in the types of goods exported and imported, almost two-thirds of our exports normally go to Canada, Latin America, and Asia, and almost three-quarters of our imports come from these parts of the world. Europe has continued, however, to be this country's chief export market for agricultural goods.

Before World War II upset the normal patterns of international trade, invisible exports and imports had become about one-fourth of this country's balance of payments.

Here, again, there has been a radical change in the American economy. During the 19th century, the United States, as a pioneer country, was a *debtor country;* that is, American business firms and the American government owed more to foreign investors than foreign business firms and governments owed to American investors. Canals, railroads, and factories were built in this country largely with capital from abroad. By the 1880's the expansion of American industry had created so much wealth in this country that Americans were beginning to invest money in foreign business enterprises, especially in Latin America. In 1913, however, American investments abroad were still much smaller than foreign investments in this country.

As a result of World War I, the United States became a *creditor country;* that is, foreign governments and business firms owed more to American individuals, business firms, and governments than American business firms and governments owed to foreign investors. This change resulted from the fact that the military operations of the Allies in World War I and the postwar recovery of Europe in the 1920's were largely financed with capital supplied by the American government and by American banks, business firms, and individual investors. In addition, American funds have financed much of the industrial development of Canada and Latin-America in the last thirty years. The fact that the United States is a creditor nation means that the flow of interest and dividend payments to American creditors from foreign debtors is greater than the flow of such payments from American debtors to foreign creditors.

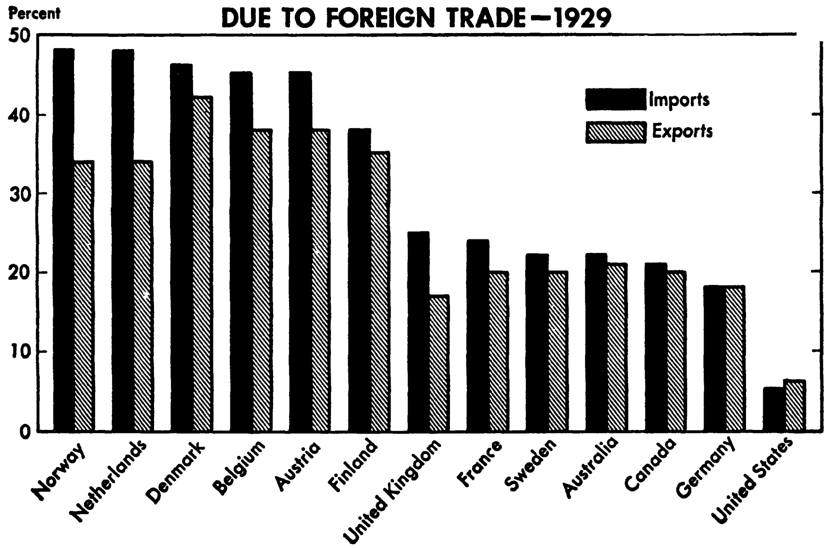
### International Economic Interdependence

There are three main types of countries, as far as international trade is concerned: (1) countries which are highly industrialized and which have reasonably adequate resources; (2) countries which are highly industrialized, but which are largely dependent on other countries for foodstuffs and raw materials; (3) countries which are primarily producers of foodstuffs and minerals, and are not highly industrialized. Examples of these types are as follows:

| *Group 1: Highly industrialized, with adequate resources* | *Group 2: Highly industrialized, with inadequate resources* | *Group 3: Producer of agricultural and mineral products* |
|---|---|---|
| United States | Great Britain | Argentina |
| Soviet Union | Germany | Canada |
| | Japan | Australia |
| | Belgium | Brazil |
| | | East Indies |

These three kinds of countries are closely intertwined. The countries in Group 2 cannot operate their manufacturing industries without foodstuffs and raw materials from the countries in Groups 1 and 3. The countries in Group 3 depend on the countries in Groups 1 and 2 for

**PERCENTAGE OF NATIONAL INCOME DUE TO FOREIGN TRADE—1929**




The relative self-sufficiency of the United States is indicated by the fact that it is the only country shown here in which imports and exports contributed less than 10% of national income. Also interesting is the fact that the United States was the only country in which exports contributed a greater percentage than imports. (Data from Twentieth Century Fund)

markets, and for manufactured goods. The countries in Groups 1 and 2 depend on each other as well as on the countries in Group 3, for markets for their surplus manufactured goods.

The chart above shows that foreign trade varies in importance from one country to another, and that for many European countries it represents a very important part of the national income. It also makes clear that the prosperity of the world depends on the free flow of goods and services.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| balance of payments | favorable balance of trade | unfavorable balance of trade |
| creditor country | import | visible export |
| debtor country | invisible export | visible import |
| export | invisible import | |

### II Questions and Problems

1) What are invisible exports and imports? Give three examples of invisible imports to the United States and three examples of invisible exports from the United States.
2) In each of the following cases, indicate whether the transaction is an export or import (for the United States), and whether it is visible or invisible: (a) An American businessman ships some textiles to Venezuela. (b) An American firm buys tin from Malaya. (c) An American takes a vacation in Canada. (d) A British businessman takes a business trip through the United States. (e) A Frenchman buys some shares in an American corporation. (f) The United States Export-Import Bank makes a loan to the government of Italy. (g) The American Red Cross ships some supplies for relief work in a flooded area of China.
3) The United States has been urged to follow a policy of developing an unfavorable balance of trade. (a) How could such a policy be carried out? (b) How would the world benefit from this development? (c) What objections might there be to such a policy?
4) (a) Explain how the countries in the three groups listed in the table on page 556 are interdependent. (b) "The interdependence of the nations of the world is similar to the interdependence of the various sections of the United States." Explain this statement.
5) The late Professor Charles A. Beard wrote several books urging this country to adopt a policy of self-sufficiency. Summarize the opinions which might be expressed about such a policy by each of the following: (a) a manufacturer of automobiles, (b) a worker in a shoe factory, (c) a cotton farmer, (d) a sheep rancher.
6) (a) Explain why Great Britain was the chief creditor country of the world during the 19th century. (b) Give the reasons why the United States changed from a debtor to a creditor country.

### III Things To Do

1) By consulting books in history, report on how each of the following influenced American trade policy: (a) Hamilton's Report on Manufactures, (b) Clay's "American System," (c) Hay's Open-Door Policy.

2) Read and summarize the graphic material on our foreign trade, in *U.S.A.: Measure of a Nation* (Twentieth Century Fund, 1949) Chapter 18.

## *LESSON* 72 PAYMENTS IN INTERNATIONAL TRADE

### Checks, Drafts, and Bank Balances

The entire system of payments in the business world is the shifting of bank balances from debtors to creditors, by the use of checks and other credit instruments. When Mr. Smith in New York City sends a check to Mr. Jones in Chicago, the final result is that Mr. Smith's bank balance is decreased and Mr. Jones' bank balance is increased.

Suppose that you live in Detroit, Michigan, but you are staying in Atlanta, Georgia. You would like to cash a check, but nobody in Atlanta knows you. You may have forestalled this difficulty, however, by having brought with you a *teller's check,* or *cashier's check,* or *bank draft.* These are different names for a check drawn by a bank against its own account in another bank. Many banks maintain deposit accounts in banks in other cities, in order to make easier the use of bank drafts for payments from one part of the country to another. Some banks maintain such accounts with banks in other countries, too, in order to handle international payments. A bank which holds deposits of other banks and which performs various services for these other banks is often referred to as a *correspondent bank.*

If you have a $100 teller's check from the Detroit bank, drawn on its correspondent bank in Atlanta, you can use it in the same way as you would your personal check. You may cash it at the bank in Atlanta, or with anyone else who is willing to accommodate you. In any case, it goes through the usual clearing process, and returns to the Detroit bank as a canceled check. The net result is as follows: (1) In Detroit you paid out $100, plus a service fee, and have that much less in cash, or in your bank account. (2) The Detroit bank has received from you $100, plus the service fee, but its balance in the Atlanta bank has been reduced by $100. (3) The Atlanta bank has paid out $100, but owes the Detroit bank $100 less.

The problem of arranging a payment between two parties in different places, with no easy means of payment from one to the other, is solved by means of the bank draft. The payment is made by arranging a transfer of bank balances. The Detroit bank, by selling you its teller's check for $100, really sold you $100 of its balance in the Atlanta bank.

In the American business world the use of bank drafts is exceptional because the use of checks is so widespread. It is a great advantage to American businessmen to have 150 million people under one government, with a stable money and banking system, and fairly uniform business laws. As a result of such factors, the risk of extending credit and accepting checks is relatively small.

In foreign trade there is no "one-world" economic system. The long distances, differences in government and money and banking systems, and other such factors make it difficult for business to be carried on as simply and safely as within a country. Bank drafts of various kinds are used, therefore, in making payments between countries.[1] The large commercial banks of every country have correspondent banks in the large cities of most other countries. A few very large banks have their own branches in the main cities of foreign countries. Through the correspondent banks, or through the branches, international payments are made with bank drafts.

### The Supply of, and Demand for, Foreign Exchange

When a bank has deposit balances in the banks of other countries, it can sell drafts against these balances to individuals and business firms who wish to send payments to the other countries. Drafts drawn against bank balances in foreign countries are referred to as *foreign exchange.* When the bank offers to sell drafts against foreign balances, it creates a supply of foreign exchange. If it offers drafts against its balances in British banks, it is creating a supply of pounds (or "sterling"). If it offers drafts against balances in German banks, it is supplying marks. If a French bank offers drafts on its balances in American banks, it is creating a supply of dollar exchange.

When individuals and business firms seek to buy drafts on bank balances in foreign countries, they create a demand for foreign exchange. If an American firm wishes to pay a bill to a Mexican exporter, there is a demand for Mexican pesos. If an Italian firm has to repay a debt to an American bank, there is a demand for dollars.

When a businessman speaks of buying foreign exchange, he means that he is paying a bank in his country to make a payment for him from that bank's account in a foreign country. When a bank speaks of selling foreign exchange, it means that it is allowing its customers to use the bank's foreign balances to make payments. By means of such transactions, an American importer of French wines pays dollars to his bank, and the French exporter receives francs from his bank. For-

[1] The description of the use of drafts, or *bills of exchange,* in international trade has been very much simplified. The form of document used does not make any difference for our purpose, since the basic principle is the same in all cases.

eign buyers of American goods pay their banks pounds, pesos, or francs; and the American exporters get dollars.

THE USES OF DRAFTS FOR INTERNATIONAL PAYMENTS

An American exporter, for example, sells some typewriters to a British firm. The payment is likely to be made in either of the following ways:

*First method*

1. The British firm buys a draft from its bank drawn on the latter's correspondent bank in America. The British bank charges the firm's deposit account for the amount of the draft, plus service fees.
2. The British firm sends the draft to the American seller, who deposits the draft in his own bank. The bank credits the seller's account, minus a service fee.
3. The American seller's bank sends the draft to the British bank's correspondent bank in this country, which charges the British bank's account for the amount of the draft, plus service charge.

*Second method*

1. The American seller makes out a draft against the British buyer, and turns it over to his bank.
2. The seller's bank sends the draft to a correspondent bank in New York City, which sends the draft to its correspondent bank in London.
3. The London bank collects the amount of the draft, plus service fee, from the British buyer, and then credits the deposit account of its correspondent bank in New York.
4. The correspondent bank in New York credits the account of the seller's bank for the amount of the draft, minus service fee.
5. The seller's bank credits the seller's account for the amount of the draft, minus service fee.

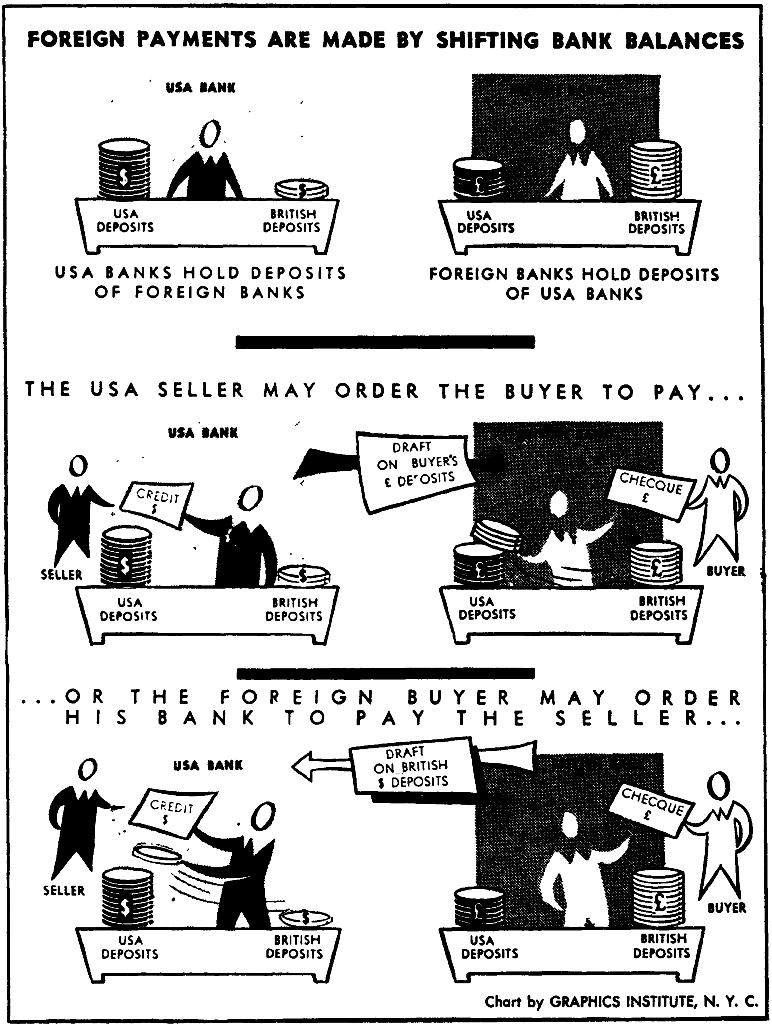
Whichever of these methods is used, the financial effect is the same. In the first method the British bank's balance in its New York correspondent bank is reduced by the amount of the transaction; the American bank owes that much less to the British bank. In the second method, the American bank's balance in its London correspondent bank is increased by the amount of the transaction; the British bank owes that much more to the American bank. The effect of payments between two countries is illustrated in the diagram on page 561.

From these cases illustrating international payments, we can make the following generalizations as to the financial effects of foreign trade.

Any payment by a person in Country "A" to a person in Country "B" affects the bank balances of the two countries in either of the following ways:

1. the deposit balances which the banks in Country "A" have in the banks of Country "B" are reduced; or

2. the deposit balances which the banks of Country "B" have in the banks of Country "A" are increased.




When a seller in the United States orders a British buyer to pay and receives payment from a United States bank, that bank's sterling balance is increased. When the British buyer orders his bank to pay, the effect is to reduce the British bank's supply of "dollar exchange" directly.

Every payment from Country "A" to Country "B" is the result of an export, visible or invisible, from Country "B" to Country "A"; which is the same thing as saying, an import, visible or invisible, by Country "A" from Country "B." We can, therefore, say that, whenever goods or services are exported from one country to another, the effect is either (1) an increase in the exporting country's supply of foreign exchange,

or (2) an increase in the importing country's demand for foreign exchange.

### The Balance of Payments

If a country's imports, visible and invisible, exceed the exports, visible and invisible, for any length of time, the banks of that country use up their bank balances in foreign countries. The country is then short of foreign exchange, and its inhabitants find it difficult to make payments to other countries. The country is in the same position as the businessman who has withdrawn all the money in his bank account. He cannot draw any more checks until he has rebuilt his balance. He has to stop buying goods and services and cannot pay his debts; unless he can get credit from his suppliers, or borrow from a bank, or has some cash outside of his bank account. The country with no foreign balances has to meet the situation in similar ways. Its businessmen have to cut down their imports of goods and services, and have to postpone paying their debts to foreign creditors. The government, or the banks and business firms, may borrow funds from the banks or governments of other countries, to restore their balances in foreign banks. As a last resort, they may use gold, instead of credit instruments, to pay for imports.

If a country's exports, visible and invisible, continuously exceed its imports, visible and invisible, then its bank balances in other countries steadily increase. This means, however, that the bank balances of the other countries shrink correspondingly. If the country with the export surplus is an important one, such as the United States, the effect may be to hinder foreign trade seriously. The other countries find themselves short of foreign exchange—in this case, dollars—and have difficulty in making foreign payments. They may have to cut down on imports or send gold to the country with the export surplus; unless the latter is willing to lend them money with which to buy. Such an unbalanced situation has existed in world trade since World War I. As a result, there have been abnormal gold flows, mainly to the United States. Drastic programs for curbing imports have been adopted by many countries. The United States has found it necessary to help other countries financially, in order that the people of these countries might buy American products.

A necessary condition for stable world trade, therefore, is that at least the important nations have adequate supplies of foreign exchange with which to make foreign payments. Each nation relies upon its visible and invisible exports to create an adequate supply of foreign exchange and thus to pay for the visible and invisible imports. For each nation there should be a balance between its outflow of payments and its inflow of payments, between its supply of, and demand for, foreign exchange.

This does not mean, however, that this balance of payments must exist between each two countries. There must be a balance, for each country, between the outflow of funds to all other countries together, and the inflow of funds from all other countries together. British firms, for example, may import more from Argentina than they sell to Argentina. At the same time, the British may sell more to Rumania than they buy from that country. The British government may have to make payments to the American government on a loan; but British investors are collecting interest and dividends from many countries. The balancing of payments is multilateral, or many-sided; not bilateral, or two-sided.

This multilateral balancing of payments in international trade did not, however, work normally after World War II; because there was an unusually large demand for American dollars. World trade was unbalanced by this shortage of dollars.

## Exercises and Activities

I Dictionary of Economic Terms

bank draft correspondent bank foreign exchange

II Questions and Problems

1) "In modern business, whether domestic or international, payments are made chiefly through the shifting of bank balances." Explain this statement.
2) In each of the following cases, describe how the payment might be made. Show the effect on supply of, and demand for, foreign exchange, and on bank balances. (a) A Brazilian firm pays for tractors bought from an American exporter. (b) An American importer pays for watches bought in Switzerland. (c) The British government makes a payment to the United States government on a previous loan. (d) An American corporation sends dividend payments to stockholders in Sweden.
3) (a) List three types of transactions which create a demand in foreign countries for dollars, or which increase the American supply of foreign exchange. (b) List three types of transactions which cause a demand in the United States for foreign exchange, or which increase the supply of dollars in other countries. (In connection with both (a) and (b), consult the balance of payments on p. 551).
4) (a) Explain what is meant by a "balance of payments." (b) List the factors which may cause a country to become short of foreign exchange. (c) Describe the situation which caused a "dollar shortage" during and after World War II.
5) (a) What is the difference between a bilateral balance of payments and a multilateral balance of payments? (b) What would be the

effect on international trade if all countries tried to maintain their balance of payments on a bilateral balance? (See p. 573.)

III THINGS TO DO

1) Bring to class and explain one of the credit instruments described in this lesson. They may be obtained from banks, businessmen, or stationery stores.
2) Obtain from a large city bank a list of its correspondent banks.
3) Draw a cartoon or a diagram to illustrate the balance of payments in international trade.

# *LESSON* 73 FOREIGN EXCHANGE

## EXCHANGE RATES

Making payments from one country to another, as you have seen, creates a problem which does not exist in making payments within a country. The money of one country must be changed into the money of another country. American businessmen want to be paid for their exports in American dollars. Canadians want to be paid in Canadian dollars, Argentinians in pesos, Britons in pounds, and so on.

As the previous lesson explained, some banks maintain deposit accounts in correspondent banks in foreign countries. A New York bank, for example, has a deposit of pounds in a correspondent bank in London, francs in Paris, guilders in Amsterdam, lire in Rome, and pesos in Buenos Aires. It is therefore in a position to sell drafts in terms of pounds, francs, lire, guilders, and pesos to people who need to make payments to those countries.

If an American importer wishes to know how many dollars he will have to pay to his New York bank in order to get a draft for 100,000 francs, he asks the bank for the *rate of exchange* for francs. The rate of exchange is the amount of one country's currency which has to be given in exchange for one unit of another country's currency. At the beginning of 1950, for example, the following rates of exchange were quoted in the newspapers:

England—about $2.80 per pound
France—about ⅓ of one cent per franc
Canada—about 90 cents per dollar (Canadian)
Argentina—about 11 cents per peso

At that time it cost an American about $280 to buy a draft for 100 British pounds, and about $300 to buy a draft for 100,000 francs.

The rate of exchange between two countries is a comparison of the values of the currencies of the two countries. When the rate of exchange for a foreign currency rises, the currency is said to *appreciate*—gain value. It takes more of our currency to buy it. If the rate for the British pound should rise from $2.80 to $3.00, then an American importer would have to pay $300 instead of $280 for a 100-pound draft on a British bank. When the exchange rate of a foreign currency drops, it is said to *depreciate*—lose value. It takes less of our currency to buy it. If the rate for the Argentinian peso were to drop from 11 cents to 10 cents, it would take only $100, instead of $110, to make a payment of 1,000 pesos. When a currency appreciates, all other currencies depreciate in terms of that currency. When a currency depreciates, all other currencies appreciate in terms of that currency.

The rate of exchange, therefore, is a price in one country for the money of another country. Like other prices, the rate of exchange is affected by changes in supply and demand. If, at a given time, this country's exports to Mexico exceed its imports from Mexico, the balances held by American banks in Mexico increase. The American banks therefore cut their charges for pesos, that is, for drafts against their Mexican balances. At the same time, the demand in Mexico for drafts on bank balances in the United States is increasing. Mexican banks can therefore charge more for dollars; that is, for drafts against their American balances. The effect is to make the dollar appreciate in terms of the peso, which is the same as saying that the peso depreciates in terms of the dollar.

### The Establishment of Exchange Rates

In the latter part of the 19th century, and in the early part of the 20th century, the determination of exchange rates was simpler than now, because most of the important countries of the world were on the gold standard. The relative values of the different currencies were determined essentially by comparing the amount of gold in the respective standard coins. Since the British gold pound, as fixed by law, contained 4.86 times as much gold as the American gold dollar, it took $4.86 in American money to buy one British pound. Similarly, the French franc was worth 19.3 cents, and the German mark 40 cents. The British pound was worth about 25 francs and about 12 marks. It was taken for granted that each country would refrain from changing the amount of gold in its standard coin. In this way the currencies of the different countries had a fixed relationship to each other, which was referred to as the *par of exchange;* that is, the value of one country's money unit in terms of another, as determined by the ratio of the metallic contents of their standard coins. Although there were several dozen money systems in-

volved in world trade, the effect was that of a single money system. Each money could be quickly translated into every other money at a definite, universally known value. The rate of exchange was always approximately equal to the par of exchange—as long as a country's foreign trade was in a balanced situation.[1]

*Chase National Bank, photo by Hurst*

The traders' section of the Chase National Bank's foreign exchange division. Sixty direct wires to financial institutions all over New York City enable the traders to execute buying and selling orders quickly.

The gold standard offered everyone a guarantee that the value of the currency of any country which was on the gold standard would be stable in relation to other currencies. This guarantee applied not only to the paper money issued by the country, but also to the bank balances in that country. People who had drafts on the banks of a gold standard country could withdraw gold from that country, if they wished, at the legally fixed price of gold. Ordinarily, however, they merely deposited their foreign-exchange drafts in their own banks, in their own countries, in the same way as checks. The guarantee of gold payment, nevertheless, stimulated international trade by creating confidence in the international money system.

Without an international gold standard system—and that has been

[1] Explanations of fluctuations of rates of exchange, gold points, and other features of the foreign-exchange market can be found in advanced textbooks.

the situation since the 1930's—there is no automatic control of exchange rates. The rate may be set by each government at whatever point it thinks will best promote its trade policies. This the government tries to do by *pegging*, or fixing, the rate of exchange. The government offers to buy and sell drafts on foreign countries, in unlimited quantities, at the legally established rates. During the greater part of the 1940's, for example, the rate of exchange between the United States and Great Britain was pegged at about $4.03 per pound. In 1949 it was changed to $2.80. No one would pay more than that price, because the British and American governments (through the banks) would supply drafts at that price. Nobody would sell drafts for less than that price because the two governments would buy them at that price.

With or without a gold standard, however, the ability of a country to keep the exchange rate fixed depends on its foreign-trade situation. Its banks must have a sufficient supply of foreign bank balances to provide all the drafts needed by their customers for foreign payments. An adequate amount of foreign bank balances depends upon an adequate amount of visible and invisible exports. If total imports exceed total exports for long periods of time, the foreign balances are used up, and the banks cannot meet the demand for drafts.

Such a continuous shortage of foreign exchange may develop from some kind of crisis, such as the outbreak of war, or a serious depression, or an economic breakdown like that in Europe after the recent war. The deficit of foreign exchange has to be offset by cutting imports, borrowing from abroad, or exporting gold. If these methods fail to solve the problem, the country's currency depreciates to a low level.

### The Effects of Changes in Exchange Rates

International trade, like domestic trade, is carried on most conveniently when there is a stable money system for making payments. Appreciation or depreciation of a country's currency may have important effects upon a nation's exports and imports.

Let us assume that the rate of exchange between the United States and Great Britain is $4.00 per pound. An American typewriter priced at $96 costs a British buyer 24 pounds. A British sweater selling for two pounds costs an American buyer eight dollars. Suppose the pound is depreciated to $3.00. Then the American typewriter costs a British buyer 32 pounds instead of 24; and the British sweater costs an American six dollars instead of eight. Depreciation of a country's currency (in this case, the pound) has the effect of cutting the prices of that country's goods and services for buyers in other countries. At the same time, it makes the cost of foreign goods higher for the people in the depreciating country. Appreciation of a country's currency (in this

case, the dollar) has the effect of raising the prices of that country's goods and services for buyers in other countries, and lowering the cost of foreign goods and services for people in the appreciating country. Thus, depreciation stimulates exports and discourages imports; appreciation encourages imports and discourages exports.

In the 1930's, when markets were shrinking, it was advantageous for a country to have its currency depreciate. It was a way of cutting prices and underselling competitors in foreign markets. To accomplish this, many countries *devaluated* their currencies. (The term *devaluation* is used to indicate an official depreciation of a currency.)

The trouble with this method of getting business was that other countries could do the same thing. This led to "currency wars" among the nations, like price-cutting among businessmen within a country. Moreover, the frequent changes in rates hindered international trade, because businessmen were uncertain as to the value of the money which they would receive for their exports.

During the 1940's, on the other hand, the main problem was the scarcity of food, raw materials, and machinery. Some countries—Belgium, Switzerland, and Sweden—appreciated their currencies, in order to make foreign goods cheaper. In 1949 Great Britain faced this dilemma: she depreciated the pound in order to increase exports, but this meant paying more for the imports of foodstuffs and materials she needed badly.

Every country has to exercise delicate judgment as to what its rate of exchange should be. If it overvalues its money in terms of other currencies, the result will be to hinder its businessmen's exports, and to face increased competition from imported goods. If it undervalues its money, it will help its exporters but raise the cost of imported goods. Therefore, decisions as to exchange rates depend largely on the relative importance of exports and imports at a given time.

### Currency Breakdowns

A country's foreign-trade situation may become so unbalanced that its currency system breaks down. Suppose France has suffered a long-time deficit in her balance of payments. The French banks have few or no balances left in foreign countries, and are unable to supply French businessmen with foreign exchange. Because the demand for foreign exchange is so much greater than the supply, French businesses offer increasingly higher prices for foreign-exchange drafts. The effect is to lower the price of francs in terms of pounds, dollars, lire, and other currencies. If this depreciation of the franc continues for a long time, the French people lose confidence in their money. They rush to exchange their paper francs for goods, and thus bid up the prices of

goods. They also try to exchange francs for gold, if any is available, and for the money of other countries in which they have more confidence.

This "flight from the franc" is like a run of depositors on a bank. Just as the depositors, when they lose confidence in their bank, try to convert their deposits into cash, so the French try to exchange their francs for goods, gold, or foreign currencies. The result is a runaway inflation, like that which occurred in China in recent years. There may even be a black market in foreign exchange, with drafts on foreign countries being sold at prices above the rate that the government may have established by law.

Because of the danger of extreme inflation, the French government tries to prevent, or at least limit, the depreciation of the franc. It may peg the franc; it may put tight controls on imports and on payments to foreign creditors, to limit demand for foreign exchange; it may borrow from foreign governments or banks, or some international agency, in order to increase its foreign balances.

Whether or not the effort to stabilize the rate of exchange will be successful depends on a variety of political and economic factors. If conditions become favorable, the depreciation eventually comes to an end, and the rate of exchange becomes stable. If not, the franc may depreciate to a value of virtually zero. It will then be necessary for the French to establish a new currency.

There have been numerous cases of extreme currency depreciation, affecting almost every country in the world, at one time or another in the past hundred years. During the past generation, especially, exchange rates have been very unstable.

### Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| appreciation | devaluation | pegging |
| depreciation | par of exchange | rate of exchange |

II Questions and Problems

1) Explain how foreign exchange rates are affected by (a) changes in the gold content of a money under a gold standard, (b) increased exports and decreased imports, (c) decreased exports and increased imports.
2) Explain how payments would be made in each of the following cases, using the present exchange rates: (a) An American store pays a British manufacturer for 120 British sweaters at 2 pounds each. (b) A Mexican railroad pays an American steel mill for $10,000 worth

of supplies. (c) An American sends a gift of $100 to relatives in Greece.

3) Explain why exchange rates were more stable in the period before World War I than they have been since that time.
4) Why did many countries devaluate their currencies during the 1930's? Why did this action have only a limited effect?
5) What are the dangers of "overvaluing" or "undervaluing" a currency?
6) Describe a flight from the currency, showing its causes and effects.
7) How might world government simplify the problems of international payments? What difficulties might be met?

III THINGS TO DO

1) Make a table of exchange rates (in terms of dollars) for each of the following countries, in the indicated years:

| | *1910* | *1920* | *1930* | *1950* |
|---|---|---|---|---|
| Great Britain | | | | |
| France | | | | |
| Russia | | | | |
| Germany | | | | |
| China | | | | |

2) On the basis of library research, summarize the arguments for and against restoration of the international gold standard.
3) Report on the reasons for the world-wide devaluation of currencies which occurred in 1949.
4) Report on the causes of currency breakdowns in these cases: Russia or Germany after World War I, Hungary or China after World War II.

# *LESSON* 74 BARRIERS TO WORLD TRADE

## WAR AND INTERNATIONAL TRADE

Some of the factors which have unbalanced international trade are (1) the world wars of the 20th century, (2) drastic changes in price and trade relationships, (3) trade barriers, and (4) international cartels.

World Wars I and II consumed the resources of the world at a record rate, while the production of foodstuffs, raw materials, and manufactured goods in Europe was greatly reduced. The United States supplied its allies with materials for carrying on the wars, and after each war helped Europe rebuild itself. As a result, world trade was distorted, during a substantial part of the twentieth century, into a one-

way flow of goods from the Western Hemisphere, especially the United States, to other parts of the world. There was a world-wide shortage of "dollars"; other nations did not have enough funds with which to make the necessary payments to the United States. The only way in which this shortage of dollars could be quickly met was through loans by the United States.

During and after World War I, this nation loaned about ten billion dollars to its allies. This increased the difficulty of carrying on world trade, because nations needed funds with which to repay the loans. In World War II, the United States tried to avoid this difficulty by using a "lend-lease" system, supplying our allies with their war needs, without expectation of money payment. Some supplies and services were received in partial payment. After the war the European Recovery Program (ERP) was used as a way of rebuilding world production and trade without increasing excessively the flow of payments to the United States. But the destruction of the productive facilities in Europe and Asia had been so great that the demand for American goods continued at an abnormally high level. The shortage of dollars was further increased by the fact that many countries were in a difficult economic situation and had unstable currencies. People throughout the world wanted American dollars, rather than any other country's money, for their goods and services. This unbalanced money situation made it difficult to carry on world trade in a normal way.

### Changes in Price and Trade Relationships

The complications in world trade, resulting from the first World War, were aggravated by the world-wide crash of business in 1930–1932. There was a sharp fall of prices, but the effects of this decline of prices varied in different countries.

Price Movements (Shown in Index Numbers, 1929–1932*)

| | *1929* | *1932* |
|---|---|---|
| Foodstuffs | 100 | 52 |
| Raw materials and semi-manufactured goods | 100 | 44 |
| Manufactured goods | 100 | 63.5 |
| All goods | 100 | 52.5 |

* Adapted from F. A. Southard, *Foreign Exchange Practice and Policy*, McGraw-Hill Book Company, 1940, p. 169.

As the above table shows, countries which exported mainly foodstuffs and raw materials suffered a proportionately greater shrinkage of income from foreign trade than countries which exported mainly man-

ufactured goods. Latin America, Australia, and Asia were more seriously affected by the deflation of prices than were the United States and Western Europe. The nonindustrialized areas of the world therefore had smaller amounts of funds for foreign payments and had to cut down their purchases of manufactured goods from the industrial countries. This loss of business was a severe blow to Great Britain, Germany, and other nations which depended on foreign trade for a large part of their national income.

### The United States as a Creditor Nation

One factor which had paved the way for trouble in the 1930's was the failure of the United States to adjust herself correctly to her new status as a creditor country. She had become the creditor of many other nations, because of two developments. During and after World War I, the United States had loaned over ten billion dollars to her European allies. Between 1920 and 1930 American banks had invested many billions in the bonds issued by the governments and business firms of foreign countries. The United States became second only to Great Britain as an investor in foreign countries.

There was one important difference, however, between Great Britain and the United States as the chief creditor countries of the world. Great Britain was accustomed to having an unfavorable balance of trade; that is, her merchandise imports exceeded her merchandise exports. This tended to cause an outflow of British funds to all parts of the world. This outflow was balanced by the flow of funds into Great Britain in payment for her invisible exports. In the case of the United States there was no such balance. This country had become a great exporter of goods, but had raised its tariffs higher and higher in order to limit imports. The favorable balance of trade created an inflow of funds from foreign countries; at the same time there was an inflow of funds because of the payment of interest and principal on the loans. This double inflow created an excessive demand for dollars in foreign countries and the supply of dollar exchange was insufficient. During the 1920's this shortage was offset to a large extent by the foreign loans made by American banks, but not completely.

Since there was a shortage of dollar exchange, the only way enough payments could be made to the United States government and to American banks and business firms was through the shipment of gold. Before World War I, the United States had possessed 25 percent of the world's supply of gold; by 1930 it had about 40 percent of the total supply; and by 1940, about 75 percent. The uneven distribution of the world's gold supply was one of the reasons for the abandonment of the gold standard by many countries during the 1930's.

THE ERECTION OF TRADE BARRIERS

At the same time, competition in world trade was becoming more intense. The businessmen of Great Britain, Germany, the United States, and Japan fought each other for business, and had to meet new competition from the growing manufacturing industries of Czechoslovakia, Switzerland, Sweden, and other countries. Faced with surpluses of goods and a decline of foreign sales, the governments of many nations used various methods of increasing exports and decreasing imports, in order to balance their international payments.

One method was the devaluation of the nation's currency; that is, lowering the value of the currency in terms of the currencies of other countries. In order to avoid losing all their gold reserves, countries abandoned the gold standard; they stopped redeeming the paper money and credit instruments in gold. Great Britain took this step in 1931, and was followed by all other countries by the end of the 1930's. Once off the gold standard, each country allowed its money to depreciate as much as it thought necessary to restore a balance of exports and imports. Some countries devalued their currencies several times. The chief difficulty was that, as one country devalued its currency, others did the same thing, or set up other trade barriers.

Some governments adopted a system of *bilateral* (two-sided) *trade*, in order to balance the amount of payments to and from each foreign country. Since it was difficult to increase exports, this system meant cutting imports from those countries with whom the balance of payments was unfavorable. Great Britain, for example, allowed her businessmen to spend for Argentinian goods no more than Argentinians spent for British goods. Since Argentina normally sold more to Great Britain than she bought from her, the effect was to cut British imports from Argentina. Germany accomplished her purpose through control of foreign exchange. Her importers could pay for foreign goods only with *blocked marks;* that is, these funds could not be withdrawn from Germany by the foreign exporters, and therefore had to be spent for German goods.

Some governments tried to stimulate exports in various ways. One way was by means of *export subsidies,* payments to exporters to make up for losses they might suffer in meeting competitive prices in the world market. The United States paid such subsidies on cotton and wheat. American exporters were told to sell cotton and wheat abroad at whatever price they could get. The government paid the difference between the world price and a profitable price. Another method of promoting exports was to extend credit to other countries, on condition that such loans be used to buy goods from the lending country. The United States made such loans through the Export-Import Bank.

### The Tariff Controversy

The most widespread kind of trade barrier has been the protective *tariff*. A *tariff*, or *customs duty*, is a tax collected on imports or exports.[1] Such taxes create revenue for the government. Import duties may also have the purpose of increasing the cost of the goods. The larger the tax, the higher the cost to the importer, who must charge a higher price to his customers. *Protective tariffs* are tariffs with high rates intended to make it difficult to sell the imported goods in competition with the domestic goods. *Free trade* is the absence of protective tariffs and other trade barriers.

In times of cutthroat competition, such as in the 1930's, the effectiveness of protective tariffs is limited. In 1930 the United States adopted the Hawley-Smoot tariff law, establishing the highest tariff rates in the nation's history. A year later, Great Britain abandoned her historic policy of free trade. Many other countries raised their tariff rates. These attempts to keep out foreign goods merely forced foreign manufacturers to find ways of producing export goods more cheaply. Low-priced imports flooded the various countries despite the tariff walls. Some countries—France, for example—therefore placed *quotas* (limits) on the importation of foreign goods, in order to protect domestic producers.

For over a hundred years the American people have argued about tariff policy. The chief argument for high tariffs has been that since American workers get higher wages than those in other countries, American manufacturers cannot produce goods as cheaply as in other countries. Tariffs, according to their supporters, must be used to protect American businesses and American workers' jobs against a flood of foreign goods. They also enable us to maintain certain industries which could not otherwise meet foreign competition, and thereby give us a more balanced, self-sufficient economic system. The dangers of specialization are avoided. This self-sufficiency is particularly important in time of war.

On the other side of the argument, the opponents of a high-tariff policy have maintained that it endangers the prosperity and peace of the world. World trade can be balanced and stabilized only if we, the richest people, buy more goods from other nations. This will operate to our benefit, because the purchases from other countries will enable them to buy more of our goods and services. This condition is especially desirable because the United States is now the creditor of the entire world, and at the same time the supplier of food, raw materials, and machinery. The payments for our goods and services can be made only if Americans buy foreign goods.

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[1] In the United States, tariffs on exports are prohibited by the Constitution.

During the first half of the 19th century, the farmers of our South and West checked the attempts of the Northern manufacturers to establish a system of protective tariffs. From 1816 to 1930, however, this country followed a high-tariff policy virtually without interruption. This policy was supported by the manufacturers and by a large part of the factory workers. Western farmers also supported it after 1900, as they began to

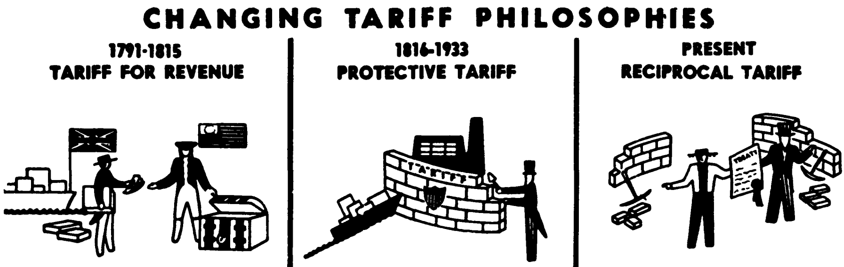



*Chart by Graphics Institute, N.Y.*

From our beginning as a nation until after the War of 1812 we exported raw materials and depended upon Europe, chiefly Britain, for manufactures. Our tariff was levied largely to get revenue. From 1816 until 1933 the aim of the tariff was to protect American business from foreign competition. Although we have not abandoned protective tariffs, the New Deal introduced the idea of reciprocal lowering of tariffs in order to increase foreign trade.

feel the competition of agricultural imports from Canada, Latin America, and Asia. In the 1930's the United States adopted a new policy, the reciprocal-tariff program, which will be described in the next lesson.

### International Cartels

Another factor which has narrowed the channels of international trade has been the monopolistic arrangement known as a *cartel.* A cartel is an international agreement among companies producing and selling the same products, in order to limit competition and fix price. The marketing agreements may include price fixing, division of territories, pooling of sales or profits, control of patents, limitations on production, and other monopolistic methods, about which you have studied. (See Lesson 38.) Some cartels have been privately organized, and some have been officially sponsored by various governments.

The American public has been rather unaware of the cartel problem, because it has assumed that the antitrust laws were keeping monopoly within bounds. During 1941 and 1942, however, it was discovered that some American companies in oil and chemical fields were linked with the I. G. Farben and other German companies. The American firms had been asked by our government to make certain technical processes available for war production; they claimed that such action would be a

violation of their cartel agreements. Public indignation forced the American companies to yield these secrets, and put the spotlight upon the cartel problem.

Since that time numerous studies have been made of the relationship of cartels to the American economy. One of these was *Cartels in Action*, published by the Twentieth Century Fund in 1946. This book described the cartels in chemicals, electric-light bulbs, sugar, rubber, nitrogen, steel, aluminum, magnesium. It claimed that 87 percent of the mineral products, 60 percent of the agricultural products, and 42 percent of the manufactured products sold in this country were affected by cartel arrangements.

Cartels, trade barriers, price changes, and world wars have violently changed the patterns of international trade during the past thirty years. As the 1940's came to an end, the nations faced a dual task: first, to restore the productiveness of the world, so that standards of living could be raised for all peoples; second, to prepare the necessary mechanisms to prevent a collapse of world trade such as had occurred in the 1930's.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| bilateral trade | export subsidies | protective tariff |
| blocked currency | free trade | import quota |
| cartel | | |

### II Questions and Problems

1) Describe at least three factors which caused the breakdown of world trade in the 1930's.
2) (a) Describe the factors which, since 1914, have made the United States the creditor nation of the world. (b) Explain how our tariff policy in the 1920's conflicted with our position as creditor nation.
3) Describe three ways in which nations tried to increase exports and decrease imports during the 1930's.
4) Give two reasons why the existence of international cartels is regarded as an evil.
5) (a) How do the foreign trade policies of the United States after World War II differ from those after World War I? (b) How does the world trade situation now compare with that of the 1930's?
6) Explain how the problem of world peace is closely related to the problem of world trade.
7) List and explain four types of obstacles or barriers to free international trade.

III THINGS TO DO

1) Read *America's Stake in World Trade* (Public Affairs Pamphlet No. 130).
2) Report on the history of the tariff in the United States.
3) Organize a forum discussion on "A Sound Tariff Policy for the United States."

# *LESSON* 75 STABILIZING WORLD TRADE

THE RECIPROCAL TARIFF POLICY

In 1930, Congress passed the Hawley-Smoot Tariff Act, raising tariff rates. In 1934, Congress passed the Reciprocal Tariff Act, which provided for the lowering of tariff rates. This shift in American tariff policy, in so short a time, was the result of the depression which had appeared in 1930. The change of policy was supported by people who realized the danger to the economic stability of world trade which had developed from tariffs and other trade barriers.

The purpose of the Reciprocal Tariff Act was to expand foreign markets for goods from the United States by opening our markets to foreign products. The President was given the power to arrange (through the State Department) *reciprocal-trade agreements* with other countries, providing for reciprocal tariff reductions. This meant that this country would reduce tariffs on specific goods from a foreign country, provided that the foreign country would reduce tariffs on specific goods made in this country. No duty was to be decreased by more than 50 percent. We would, for example, reduce the duty on woolen goods from Great Britain, if Great Britain reduced her duty on automobiles from the United States.

The policy of reciprocity has been hailed by some people as a landmark in the history of international trade. The United States offered leadership to the world in lowering trade barriers. Under this law more than twenty reciprocal tariff agreements were made with various countries of Europe and Latin America, as well as with Canada. The effect apparently was favorable to American business, because, during the later 1930's this country's exports to countries with which it had reciprocity agreements increased more than its exports to countries with which it had no such agreements.

Criticism of this policy came from two sources, however. Many farmers of the Middle West feared that the reduction of tariffs on foodstuffs

would bring increased competition for them. Similar fears were expressed by businessmen and labor organizations in such industries as shoes, textiles, and watches. On the other hand, some economists argued that the reciprocal tariff program was an inadequate step toward expanding world trade. It helped to increase American exports and imports; but did not change the basic situation—this country's favorable balance of trade. As a creditor nation, these economists claimed, the United States must increase its imports enough to make its balance of trade (the balance of visible items) unfavorable.

### Wartime Lend-Lease

World War II interrupted normal trade relationships. The ordinary trade of American business firms with the continent of Europe was virtually wiped out. But the United States became the arsenal of democracy. It supplied a large part of the foodstuffs, machinery, and military equipment with which to defeat the Axis. Instead of selling these goods to its Allies, however, the United States gave the goods to them on a *lend-lease* basis. The goods, not money, were loaned, and the borrowing nations were not expected to pay in money for these goods. Altogether, the lend-lease operations, between 1941 and 1945, amounted to nearly 50 billion dollars. Some of the Allies gave us "reverse lend-lease," in the form of food, supplies, and services for our armies abroad, amounting to about 5 billion dollars. But it was understood that the lend-lease operations were not to create any debt.

The United States used the lend-lease system instead of selling on credit, partly because of the experience which this country had had with the war debts of World War I. The United States, with its policy of excluding imports by means of high tariffs, helped to bring about a shrinkage of world trade, which virtually destroyed the ability of the European nations to get the money to repay their war debts.

When the same problem arose in the 1940's, Americans realized that they could not hope to collect war debts after the war, unless they were prepared to allow a flood of foreign goods into this country; and even this might not be an adequate remedy. It was decided that the wisest policy was to give war supplies to our Allies, without any obligation to pay for them after the war. The developments since the war have proved the wisdom of this decision. The nations of Europe and Asia have had the utmost difficulty in getting back to a normal trade basis, without the burden of paying back 50 billions in war debts.

### The European Recovery Program

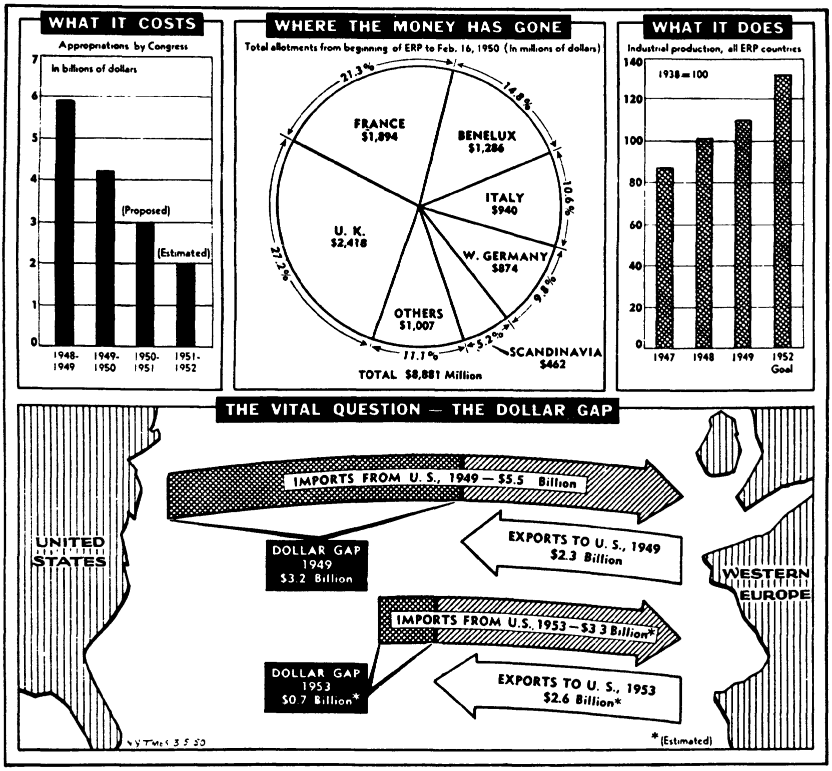
When the war came to an end, in 1945, this country faced the responsibility of helping the world return to a peaceful and prosperous basis.

There was widespread fear that unless this were achieved with reasonable speed, many countries in Europe and Asia might, in desperation, adopt a communist government. The United States sent relief supplies to many countries; and made emergency loans to several countries, including one loan of four billion dollars to Great Britain. These loans proved inadequate, however, for the tremendous job of reconstruction that was needed. Accordingly, the United States, in 1948, adopted a much larger program of aid, originally called the "Marshall Plan," and later known as the "European Recovery Program."

The European Recovery Program (ERP) was established for the purposes of providing (1) emergency relief to the European countries whose people lacked the necessities of life, and (2) the means of rebuilding their industries, so that they could return to a normal economic situation. The program was intended to include all the countries of Europe, but the Soviet Union and the other Communist states declined to participate in the program. The participating countries were Great Britain, Eire, Norway, Sweden, Denmark, Western Germany, the Netherlands, Belgium, Luxembourg, France, Switzerland, Austria, Italy, Iceland, Greece, Turkey, and Portugal.

The ERP was an attempt at international economic planning. Representatives of the participating nations met for many weeks to draw up a balance sheet of their resources and needs. On the basis of this analysis, the United States agreed to provide 17 billion dollars, over a period of four years, ending in 1952. It was expected that about 80 percent of the 17 billions would be given as grants, while the remaining 20 percent would be loaned. The program was carried out by an American agency, the Economic Coöperation Administration (ECA). The money was spent mainly in the United States, but also in Canada and Latin America, to acquire foodstuffs, raw materials, and machinery. How the total amount of aid was divided among the participating countries was to be decided by the European countries themselves, through their Organization for European Economic Coöperation. The OEEC worked closely with the ECA.

Certain conditions were attached to the ERP. Each nation, in order to receive aid, had to sign an agreement promising to (1) increase industrial and agricultural production as much as possible, (2) take necessary measures to balance its budget and stabilize its money system, (3) coöperate with other countries in reducing trade barriers, (4) supply "strategic materials" to the United States, (5) set up a "counterpart fund," in its own money, equal in value to the amount of aid received from the United States, this fund to be used, upon approval by the ECA, for reducing the government debt, stabilizing the currency, or increasing production of goods.




The New York Times

The graphs at the upper right and left show that ERP expenditures are expected to decline as production in the countries assisted rises. The pie chart (upper center) shows the shares received up to February, 1950. The map below shows how the need arises from the "dollar gap," the difference between foreign exports and imports.

As the 1940's came to an end, it was not yet clear how successful ERP would be. There were various signs of progress. After the program had been in effect for only a few months, the relief phase of ERP was largely accomplished, and the work of reconstructing European industry was begun. By 1950, the production of farm products, minerals, and finished goods generally reached prewar levels, though still below the needed amounts. There had been a small, but noticeable, rise in the standard of living in most parts of Europe. The shortage of dollar exchange was somewhat lessened, as a result of two developments. Exports of goods from European countries to the United States increased as a result of increased production. Imports from the United States were cut, because the European countries followed a policy of "austerity," restricting the

standard of living, and tried as much as possible to buy from one another.

Despite these favorable developments, there was much doubt as to the final results. Developing real economic coöperation among the nations of Europe was not proving an easy task. Each nation feared that lowering its tariffs and other trade barriers might increase its imports too much and exhaust its supply of foreign exchange. Some Europeans felt that the veto which the ECA could exercise over the use of the counterpart funds would give the United States excessive control over the European nations. They also foresaw the possibility that if a tendency toward depression appeared in the United States, the ERP might be used as a means of dumping surplus American goods in Europe, in competition with European industries.

The dollar deficit was being reduced too slowly, because American imports of European goods and services were not expanding enough. Some experts believed that the dollar deficit of the European countries was likely to continue for a long time. This led to the question whether the United States would be willing to continue the ERP indefinitely, or would be willing to increase its imports by the huge amounts necessary to eliminate the dollar shortage. (See chart p. 582.)

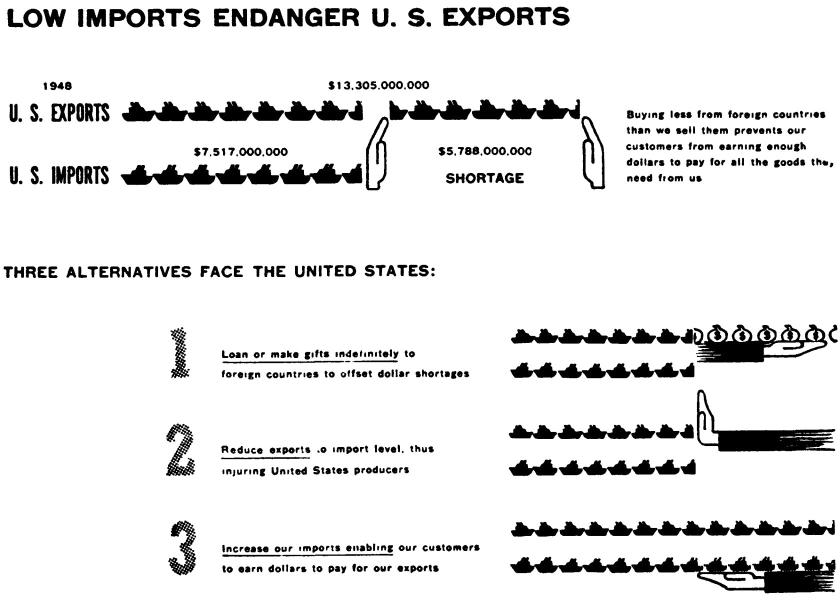
Another difficult question was whether Europe could become prosperous again without restoring the prewar industrial production of Germany. The American government favored restoration of German industrial production to a high level. But the British feared a rebuilt Germany as a competitor, and the French feared a rebuilt Germany for military reasons. The problem was further complicated by the division of Europe into two hostile blocs, the Soviet group in the East, and the Western group. Many people said that European production and trade could not be wholly rebuilt unless a normal amount of trade was reestablished between the Eastern and Western groups. Moreover, there was danger that the huge amounts being spent by the European countries (with American aid) for military purposes would defeat the purposes of the ERP.

### International Economic Coöperation

Meanwhile the nations of the world were developing, through the United Nations, broad plans for international economic coöperation. These plans had various aims: (1) giving relief to war-stricken areas, (2) repairing the damage done to agriculture and manufacturing during the war, (3) developing new industries as a means of raising standards of living, (4) stabilizing currencies and reducing trade barriers, (5) balancing agricultural surpluses and deficiencies.

One of the major bodies of the United Nations has been the Eco-

nomic and Social Council, consisting of eighteen members elected by the General Assembly. This Council was established because the events of the past generation had taught that hopes of achieving permanent world peace depended on solving the world's economic and social problems. If the peoples of the world could eliminate economic insecurity, poverty, racial discrimination, and imperialism; if we could increase world production of goods and services, raise standards of living in the




A wide "dollar gap" between exports and imports creates a problem of trade policy.

backward areas, and establish universal standards of human rights—perhaps we could have peace. The Economic and Social Council handles such varied problems as improving health services in all parts of the world, gathering statistics on economic and social developments, improving transportation and communication, establishing an international bill of rights, and promoting better education in all countries. It studies these problems and makes recommendations to the member nations. It coördinates the work of specialized United Nations agencies, such as the World Health Organization, the International Refugee Organization, the Food and Agriculture Organization, the International Bank, and the United Nations Educational, Scientific, and Cultural Organization (UNESCO).

The International Bank for Reconstruction and Development was created to provide capital for rebuilding countries devastated by the

war, and for creating new industries in the less developed areas of the world, such as Africa, Asia, and Latin America. The Bank can provide capital in two ways. It can make loans and it can guarantee loans made by private banks to foreign governments.

The purpose of the International Monetary Fund (IMF) is to stabilize the exchange rates of the currencies of the various nations who support the Fund. Each of these nations has been required to set a fixed value for its currency in terms of gold, or in terms of the United States dollar; and may not change this value by more than 10 percent without the permission of the governing body of the Fund. The Fund can make loans of foreign exchange to any member country which is short of foreign exchange. The purpose of the loan is to make it unnecessary for the country to restrict foreign payments or to depreciate its currency. When the emergency is over, the country is expected to repay the loan to the Fund. The amount of aid which a country may receive from the Fund is in proportion to the amount of capital which the country has supplied to the Fund. Although the IMF has given some help in minor cases, it could not prevent world-wide devaluation of currencies in 1949.

The task of the International Trade Organization (ITO) is to coördinate the trade policies of the nations, so that world trade will be expanded, not contracted. The nations who signed the charter of the ITO, at Havana in 1948, agreed that they would (1) take measures to create full employment within their own countries; (2) encourage foreign investments in their own countries, without discrimination against any particular group of foreign investors, provided that foreign investors and their governments did not interfere in the internal affairs of the country; (3) avoid any actions which would create difficulties for other nations in making international payments; (4) use trade barriers only as temporary measures, to prevent excessive inflation or to check unemployment, such trade barriers to be applied to all nations equally; (5) limit monopolistic practices (cartel arrangements) in international trade, either by private firms or public agencies; (6) limit use of production and price controls to situations involving large surpluses or large amounts of unemployment. In 1949, the nations participating in the ITO signed a group of treaties providing for reciprocal tariff reductions. The broader purposes of the ITO still remained, however, in the blueprint stage.

The Food and Agriculture Organization (FAO) is attempting to develop on a world-wide scale the kind of farm program already in operation in the United States. On the one hand, it aims to spread scientific and mechanized farming methods in the backward areas of the world, so that their standard of living may be raised. On the other hand, the FAO hopes to develop international arrangements to absorb surplus

farm products, and to shift surpluses to those areas where they may be needed.

The International Refugee Organization (IRO) provided relief for the refugees and displaced persons in various parts of Europe, and helped these people to find permanent homes in various parts of the world.

The International Labor Organization (ILO) was transferred from the League of Nations to the United Nations. It consists of representatives of labor, management, and government from each of its member nations. Through its annual meetings, the ILO is attempting to set up international standards of wages, hours, and working conditions. These standards cannot be imposed upon any country; but it is hoped they will gradually be accepted.

### The "Bold New Program—Point Four"

In 1949, international economic coöperation was advanced another step, although the size of the step remained to be determined. This was the announcement by President Truman (the fourth point in his inaugural address) of a "bold new program" for the improvement of underdeveloped areas of the world, through the use of American capital and technology. The plan was outlined in these words:

> We must embark on a bold new program for making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas.
>
> More than half the people of the world are living in conditions approaching misery. . . . For the first time in history, humanity possesses the knowledge and the skill to relieve the suffering of these people.
>
> I believe that we should make available to peace-loving peoples the benefits of our store of technical knowledge in order to help them realize their aspirations for a better life. And in coöperation with other nations, we should foster capital investment in areas needing development.
>
> Our aim should be to help the free peoples of the world, through their own efforts, to produce more food, more clothing, more materials for housing, and more mechanical power to lighten their burdens. . . .
>
> This should be a coöperative enterprise in which all nations work together through the United Nations and its specialized agencies wherever practicable. It must be a world-wide effort for the achievement of peace, plenty, and freedom. . . .
>
> The old imperialism—exploitation for foreign profit—has no place in our plans. What we envisage is a program of development based on the concepts of democratic fair dealing.
>
> All countries, including our own, will greatly benefit from a constructive program for the better use of the world's human and natural resources. Ex-

perience shows that our commerce with other countries expands as they progress industrially and economically. . . .

Democracy alone can supply the vitalizing force to stir the peoples of the world into triumphant action, not only against their human oppressors, but also against their ancient enemies—hunger, misery, and despair.

Since the announcement of the plan, steps have been taken by Congress, and by the United Nations, to put the plan into effect.

### Exercises and Activities

I Dictionary of Economic Terms

lend-lease

reciprocal trade agreements

II Questions and Problems

1) (a) Why did a thousand American economists sign a protest against the Hawley-Smoot tariff bill, when it was being considered in Congress in 1930? (b) Do you think the economists were right? Why or why not?
2) (a) Explain how the Reciprocal Tariff Act of 1934 changed American tariff policy. (b) What were the reasons for this change? (c) How does the International Trade Organization carry this tariff policy further?
3) The United States has been charged with failing to go far enough in removing trade barriers in order to increase American imports. What evidence could you give for and against this charge?
4) (a) How did the lend-lease program show that the United States had learned from experience? (b) Why did the "dollar gap" develop after World War II, despite the use of lend-lease?
5) (a) Explain how the European Recovery Program attempted to improve world economic conditions. (b) What factors limited the success of ERP?
6) Describe five ways in which the United Nations has been trying to improve economic and social conditions. How much progress has been made?
7) Examine the chart on page 580, showing ERP aid. (a) Summarize in a table the proportions of the total going to each of the areas mentioned. (b) Do you think it was worth investing this huge amount? Why or why not? (c) What relationship is there between the graphs on pages 580 and 582?
8) An economist once remarked, "During the 19th century, the United States, as a debtor nation, was on the receiving end of an undesignated Point Four program. Now it is the turn of the United States to be at the other end of such a program." Explain this statement, and give your reasons for agreeing or disagreeing with it.

9) Show how the effort to stabilize world trade has been, or may be, affected by each of the following facts: (a) The development of manufacturing in "backward countries" increases. (b) Growing competition in Latin America is felt by the American textile industry. (c) The United States government is urged to put quotas on imports of petroleum into this country. (d) Great Britain limits purchases of American petroleum by business firms in British-controlled areas of the world. (e) Efforts to reduce trade barriers in Western Europe fail. (f) Brazil asks for more loans from Export-Import Bank to develop Brazilian steel industry. (g) Millinery, shoe, and watchmaker unions in the United States demand higher tariffs on competing imports. (h) A depression develops in the United States.

## III Things To Do

1) Read and report on "President Truman's Fourth Point and the United Nations," *International Conciliation* No. 452 (published by the Carnegie Endowment for International Peace, 405 West 117th Street, New York 27, N.Y., June, 1949). This is a brief explanation of the Point Four program, its relationship to the United Nations, and its differences from the European Recovery Program.
2) Report to the class on the current status of (a) ERP, (b) the Point Four program.
3) On the basis of library research, report on the "most favored nation" policy of the United States, and its relationship to reciprocal trade agreements.

# *UNIT* 13

# GOVERNMENT AND TAXATION


*76* PUBLIC SERVICE AND PUBLIC FINANCE

*77* TAXES AND BUDGETS

*78* PROBLEMS OF TAXATION

*79* PROBLEMS OF FISCAL POLICY

# LESSON 76 PUBLIC SERVICE AND PUBLIC FINANCE

## Government Services

Every person in the United States receives the services of the federal government, his state government, and his local governments. These services have become more extensive as our political, economic, and social institutions have become more complicated. They have, at the same time, become more and more expensive. The problem of *public finance* is twofold: (1) to determine the funds needed by government, and (2) to find ways and means of raising these funds.

The services of government, particularly local government, contribute directly to our standards of living. Yet many of the services are so much a part of daily life that they are hardly noticed. People take for granted paved streets, sidewalks, roads, parks, hospitals, water supply, playgrounds, garbage removal, sewage disposal, public schools, and other such services. For the individual these services are a "free income," which raises his standard of living. As standards of living rise, the demand for government services grows—free college education, housing projects, adequate medical and hospital services, more parks and beaches. The cost of government projects and services continues to expand. Free income to consumers requires a high level of government expenditure.

As population, cities, and industries grow, government controls become more complex and more costly. The police, fire, judicial, welfare, and health departments of government take on more and more functions, employ more individuals, and acquire expensive buildings and equipment. Previous lessons have described the broadening of government regulation of economic affairs. Such activities as supervision of banking, insurance, public utilities, stock exchanges, big business, labor relations, and farm prices have resulted in the multiplication of governmental agencies and have multiplied government expenses for personnel and for administrative organization.

Government provides financial assistance to individuals and businesses. Local, state, and federal governments make payments to the aged, sick and infirm, widowed and orphaned, and unemployed. During the depression, billions of dollars were spent to reduce suffering and to restore the flow of purchasing power into the consumption of goods. In addition, loans and subsidies to farmers, real-estate owners, banks,

insurance companies, railroads, and others, saved many enterprises from insolvency. Subsidy of shipbuilding and aviation through mail contracts has been common.

Government departments and their experts serve industry in many ways. As important to the business firm as to the individual are law and order—protection against burglary and fire, judicial enforcement of contracts, safeguarding of ideas and inventions through patents and


*Evans in* Columbus Dispatch

**Trying to satisfy demands for more services and lower taxes is difficult.**

copyrights. The businessman relies upon the government to maintain an efficient money and banking system, and to provide roads, tunnels, bridges, airports, and post offices. In the federal government the Department of State negotiates commercial treaties. It employs consuls in the chief cities of foreign countries to protect the persons and business interests of American citizens. The Department of Commerce seeks ways of expanding trade opportunities and conducts research regarding business conditions. Its Bureau of Standards makes its findings available to industry. The Weather Bureau has been of inestimable assistance to agriculture and other industries. The Department of Interior serves extractive industry in a variety of ways. The Department of Agriculture serves the farmer in his producing and consuming activities. The

Department of Labor offers labor conciliation services. Similar services are offered by many state and local government agencies.

Governments are playing an increasingly important part in technological and scientific progress. The most spectacular example is the development of atomic energy. No private group could have risked the billions of dollars which have been, and are being, spent by the government to translate theories into practical results. The Department of Agriculture has studied control of insects, grain rust, and animal diseases. The Bureau of Mines works on the problem of controlling explosive gases and dusts in the coal mines. The Bureau of Standards searches for mildewproof textiles, and for house paints which will be less affected by sunlight. The Bureau of Labor Statistics studies the spending habits of the families of workers in cities throughout the country. State and local agencies have studied such problems as safer highways, traffic control, sewage disposal, and prevention of epidemics.

Government operates some productive enterprises. The federal government produces and sells electric power in the Tennessee Valley region. Many local governments own and operate transportation systems or power plants. If these are self-supporting, they involve no net expense. Occasionally they may yield a net income. If, however, they are run at a loss, they may provide the public with cheap goods or services, but their maintenance is a net expense to the government.

As this country's role as a world power develops, the expense of maintaining this position grows. Participation in agencies of world government, such as the United Nations, the International Bank, and others, costs money. Billions have been expended in programs for the relief, rehabilitation, and armament of foreign nations under the terms of the European Recovery Program, the Truman Doctrine, and the regional defense pacts. Expenditure for national defense has become a heavy burden.

The financial effect of mounting government service is shown in the table which follows:

GOVERNMENT EXPENDITURES, 1890–1948*

(IN MILLIONS OF DOLLARS)

| | *1890* | *1913* | *1928* | *1940* | *1948* |
|---|---|---|---|---|---|
| Federal | 290 | 690 | 3,970 | 8,875 | 41,450 |
| State | 80 | 385 | 1,825 | 3,680 | 6,720 |
| Local | 480 | 1,845 | 6,815 | 5,745 | 7,840 |
| Total | 850 | 2,920 | 12,610 | 18,300 | 56,010 |
| Per Capita (in dollars) | 13 | 30 | 105 | 139 | 384 |

* Adapted from data of the National Industrial Conference Board

In the year 1948, total expenditures of all governments in this country were 65 times as large as they had been in 1890, over 18 times as large as in 1913, and three times as large as in the prewar year 1940. A better basis of comparison is the expenditures per capita, since this allows for the growth of population. The expenditures per capita in 1948 were about 30 times as great as they had been in 1890, and three times as great as in 1940. In studying these figures, however, we must also keep in mind the changes in prices and incomes which have taken place during the period.

### Government Spending and Individual Incomes

Just as businessmen must pay for the factors of production, so must the government pay for what is necessary to the performance of its functions. It must pay wages and salaries to officials, experts, and all those who provide labor of one kind or another. It must purchase supplies, equipment, and materials for roadbuilding, for the armed forces, and for its numerous offices, agencies, and projects. No single private enterprise in the nation employs as many people, or spends as much on goods, as does the federal government. The government also pays interest on the sums which it has borrowed to help meet its vast need for funds. The result is that the government is responsible for a large proportion of the amounts paid out as income to individuals and businesses.

The table on page 593 shows in round numbers the billions of dollars of income which were created by federal payments in 1947. In that year the total national income was 202½ billions. Federal payments accounted for about 31½ billion dollars worth, or over 15 percent. It is probable that payments by state and local governments amounted to not less than an additional 10 billion dollars; this would bring the total of government payments of income to about 20 percent of national income.

By creating incomes for individuals and business enterprise, government spending can greatly influence the economic system. Increased government spending has the effect of increasing the spendable income of consumers and industry. If it stimulates consumer spending or investment in capital goods, it may help produce a trend toward inflation. A sharp cut in government spending may produce the opposite effect of reducing buying and investment, and introduce a deflationary trend.

Government expenditures have political consequences. The more the government spends, the greater is the number of jobs, contracts, and subsidies to be distributed by the political party elected to office. Government expenditure is the economic basis of political patronage. Charges of waste and corruption in government spending are a familiar

part of campaigning for office. Payments by government to groups, such as welfare payments, aid to farmers, and subsidies to industry, become political issues. Government spending tends to invite competition for economic favors from the government.

### Government Income and Individual Incomes

Government receipts of funds are referred to as *revenue.* Some government activities produce revenue—for example, publicly operated enterprises like power plants or transit systems. Loans by government

Direct Creation of Income by the Federal Government, 1947*

| *Types of Payment* | *Amount in Millions* |
|---|---|
| TO INDIVIDUALS | |
| Federal personnel—military | $ 3,500 |
| " " —civilian | 6,100 |
| Pensions and benefits to veterans | 6,900 |
| Social-welfare beneficiaries | 1,900 |
| Interest on federal debt | 1,400 |
| TOTAL TO INDIVIDUALS | 19,800 |
| TO BUSINESS | |
| Payments for goods and services | 8,500 |
| Aid to farmers | 800 |
| Interest on federal debt | 2,300 |
| TOTAL TO BUSINESS | 11,600 |
| TOTAL TO INDIVIDUALS AND BUSINESS | 31,400 |

* Adapted from Table 6, *Economic Reports of the President,* January, 1948, p. 29.

agencies may yield revenue in the form of interest. Admissions to parks and beaches, or tolls on roads and bridges, if in excess of costs of maintenance, provide revenue. Another source of revenue is *fees,* payments for licenses or permits granted by the government to individuals or businesses. However, most government revenue comes from taxation and not from fees or from income earned by government enterprise.

A *tax* is a payment of money to the government which is required by law. Its payment is compulsory and enforced by the legal machinery of the government. Failure to pay may mean fine or imprisonment. Property may be seized by the government, sold at public auction, and the proceeds applied to the payment of taxes due. In bankruptcy proceedings, unpaid taxes must be paid out of the firm's assets before private creditors may receive any payment.

If government revenues in any year are greater than the expenditures, a *surplus* is said to exist. The surplus may be used to reduce the amount

to be raised by taxation for the year following, or to repay some of the government's debt, or it may be held in reserve for an emergency.

If government revenues in any years are lower than the expenditures, there is a *deficit.* If a surplus remains from the previous year, it may be used to balance the deficit. However, government deficits are usually covered by borrowing. Government borrowing involves the issuance of interest-bearing credit instruments, usually bonds. Government bonds are purchased by investors in this country and other countries. The total owed by the government is called the *public debt.* In this country it is the sum of the federal, state, and local-government debt. Each year these governments must set aside funds to pay the interest on the debt; this payment is called *debt service.* An increase in public debt means an increase not only in the amount owed, but also, usually, an increase in the sum needed for debt service.

As government expenditure rises, the taxes and debt also tend to rise. In 1913, federal, state, and local taxes amounted to approximately $23 per capita, and took about 7 percent of the national income. By 1936, the per-capita burden of taxes had risen to $82, and the volume of taxation had risen to about 17 percent of national income. In 1949, the per-capita payment of federal, state, and local taxes was almost five times as great as in 1936, about $380 per capita, taking about 25 percent of the national income. Yet this huge increase in taxation has not been adequate to finance the mounting volume of government expenditure. This is revealed by the increase in the public debt. In 1920, the per-capita public debt was approximately $228; in 1949, it was $1749. The net public debt of the federal government in 1947 had reached a total of about 250 billion dollars, and the state and local-government debt amounted to over 14 billions.

The means used to raise these huge sums are of major importance to the workings of the economy. Taxation reduces the expendable incomes in the hands of individuals and business enterprises. Money paid to the government as taxes cannot be spent by taxpayers on goods or services or invested by them in private enterprises. Through taxation the government takes away part of the national income, and spends, invests, or saves it. Hence taxation substitutes government spending, government investment, and government saving for spending, investment, or saving by individuals. On the other hand, government spending and saving may help to increase the national income, thereby increasing expendable incomes.

The processes of government spending and of government financing result in the redistribution of a large part of the national income. Tax laws, to some extent, determine who shall have money to spend, save, and invest. Government takes or borrows from some, and gives or lends

to others. Thus public finance has an importance which goes beyond providing funds for necessary government services. Public finance is a vital factor in the economic and social system.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| debt service | public debt | revenue |
| deficit | public finance | surplus |
| fee | | tax |

### II Questions and Problems

1) Make an outline of some of the most important services rendered by the government to each of the following: (a) consumers, (b) workers, (c) businessmen, (d) the community as a whole.
2) People talk about the "good old days" when government had much less to do with our daily lives, and taxes were much lower. Do you agree or disagree that such days were better than the present? Explain your answer.
3) The government is thought of as being the servant of the people, and also the master of the people. Show, by specific examples, the basis of each viewpoint. Which viewpoint do you think is more valid? Why?
4) Explain how the increasing quantity and variety of government services are (a) the result of the industrial revolution, (b) a means of increasing or decreasing our incomes.
5) The National Bureau of Economic Research reported, in 1949, that in 1900, one out of every twenty-four American workers was on a government payroll; in 1948, one out of every nine workers was a public employee. What conclusions would you draw as to the causes and effects of this change?
6) The statement has been made that "big government" has become a threat to democracy. (a) What is the basis for this statement? (b) Explain why you agree or disagree with the statement.
7) Note the figures on page 594, showing the increase in percentage of national income taken by taxes. (a) What are the reasons for this change? (b) What do you think have been the results of this change?

### III Things To Do

1) Ask several people what they think about the fact that taxes take about one-fourth of the national income. Report to the class.
2) Report to the class about some current proposal for adding to the functions of the government. Explain why you approve or disapprove of the proposal.

# *LESSON* 77 TAXES AND BUDGETS

## Types of Taxes

As a result of the search for sources of revenue, taxes have multiplied. That which is taxed is called the *tax base*. In the case of the *poll tax*, still used in a few states, the tax is levied as a fixed sum per person. For the most part, however, the tax base is some economic factor, such as income, ownership of personal or real property, wealth transferred by will or gift, or goods manufactured or sold. A tax law may provide for a fixed amount of tax, as for example, a tax of three cents on each gallon of gasoline sold. Most taxes, however, are levied as a percent of the tax base. This percent is called the *tax rate*. Thus the federal tax rate on jewelry, in 1949, was 20 percent of the value of the goods at retail.

Income taxes are based on the annual income of individuals and corporations. Those paid by individuals are referred to as *personal income taxes;* those paid by corporations are called *corporate income taxes.* An income tax is levied by the federal government and by about two-thirds of the states. Another form of income tax, used occasionally, is the *excess-profits tax,* which is an additional tax on business profits in excess of a stated amount. It was levied by the federal government during the war years, not only to raise revenue, but also to discourage profiteering when goods were scarce and prices high.

A *property tax* is an annual payment of a percent of the value of property owned. The most common property tax is that on real property or real estate—an annual payment of a percent of the value of land and buildings owned. It is levied by local governments and is their chief source of revenue. The value of the real property, as fixed by the government for purposes of computing the tax, is called the *assessed value.* The tax rate is usually quoted as a given number of dollars per hundred, or per thousand, dollars of assessed value. Thus, a tax rate of \$3 per hundred, or \$30 per thousand, means a tax of 3 percent of assessed value. With that rate, on property assessed at \$50,000, the amount of tax would be \$1,500.

An *estate* or *inheritance tax* requires payment of a percent of property left at death. If paid out of the estate, prior to division among the heirs, it is an estate tax; if paid by the heirs out of their shares after division, it is an inheritance tax. An exemption of a definite sum is allowed, so that no tax is paid on small estates or inheritances. Under the federal estate tax, for example, no tax is chargeable on the first \$60,000 of property. To forestall evasion of estate and inheritance taxes by

transfer of property prior to the death of the owner, a *gift tax* is also levied. The gift tax provides for the payment of a percent of the value of property acquired by gift. This too is subject to exemptions, so that some property may be given away without payment of a gift tax.

Numerous taxes are levied on the domestic manufacture, sale, or transfer of goods or services during the normal course of business operations. These are called *excise taxes*. A manufacturer's excise tax is a tax paid on the manufacture of goods or services. In 1949 there were federal excise taxes on many products including tobacco, automobile chassis and parts, firearms, gasoline, guns, tires and tubes, refrigerators, sporting goods, musical instruments, photographic apparatus and supplies, electric-light bulbs, liquor, oleomargarine, and other products. States also levied manufacturer's excise taxes, often on the same products taxed by the federal government. Some of these are collected by the sale of revenue stamps to manufacturers, and others are paid by manufacturers as a percentage of sales. A retailer's excise tax is a tax paid by retailers on the retail sales of specified products. In 1949 the federal government collected, from retailers, taxes on jewelry, furs, cosmetics, luggage, watches and alarm clocks. Excise taxes are also levied on services. Thus there are federal taxes on admissions to theaters and other recreational activities, on transportation, on telephone, cable, and telegraph services, and on safe-deposit boxes. Many states and local communities levy a *sales tax*, which is a tax on wholesale or retail sales of goods and services in general, although foods, medicines, and personal services are often exempted. The sales tax is levied as a fixed percent of the selling price.

Another tax levied on goods is the tax on imports, called a *tariff* or *duty*. It may be levied merely to raise revenue. Often, however, it aims at discouraging the importing of the commodity on which it is levied, to protect domestic producers from foreign competition. Hence it is often called a *protective tariff*. Because protective tariffs tend to limit the imports of the products taxed, they do not provide large revenues. A tax on exports is prohibited by our Constitution. Other countries, however, have made use of this form of tax. Chile, when natural nitrates were in demand, made export duties on nitrates its chief source of revenue.

Social-security legislation has introduced two additional kinds of taxes. The *payroll tax* is a percent of payroll paid by employers to defray the expenses of old-age pensions and unemployment insurance for employees. In addition, employees pay a tax on wages, often called a *social-security tax*, toward their old-age pensions. The tax is deducted by the employer from the workers' wages and paid by the employer to the government.

PAYING PERSONAL INCOME TAXES

Income-tax rates are not uniform for all taxpayers. Individual rates differ from corporate rates; the rates also vary with the size of the income. The federal tax rate on personal incomes earned in 1949 was 20 percent on the first $2000 of taxable income, 22 percent on the next $2000, 26 percent on the next $2000, and so on until the rate reached 91 percent on taxable incomes above $200,000. Such a tax rate, varying with the level or *bracket* of income, is called a "graduated rate."

The amount of income tax which a person pays depends on three factors. The first is the amount of the person's earnings; that is, his gross income. The second is the number of exemptions which the taxpayer is given for himself and each of his dependents. A dependent is a close relative (wife or husband, child, in-law, uncle, aunt, nephew, niece, or close relative by law) who does not have an income above a specified amount, and who gets more than half of his financial support from the taxpayer claiming him as a dependent. For each exemption the taxpayer may subtract a specified amount from the gross income. The third factor is the deductions made by the taxpayer; that is, the amount which the taxpayer is legally allowed to subtract from his gross income because of contributions to charitable, religious, educational, and civic organizations; interest paid on personal loans; certain taxes; medical and dental expenses above a minimum amount. Subtracting exemptions and deductions from gross income leaves the *taxable income*, on the basis of which the tax is calculated.

For most people, paying the income tax has been made simple and convenient through the use of the *withholding tax*. An amount is deducted by the employer from the pay of the worker, with the expectation that, at the end of the year, the deductions will approximately equal the total tax due to the government. The amount withheld depends upon the amount of wages and upon the number of exemptions. The rate of the withholding tax is calculated so as to allow automatically a standard deduction for contributions, medical expenses, and so on.

At the beginning of each year every employer must give a *withholding statement* to every person who has worked for him during the previous year. This statement is a slip showing the total amount of wages paid by the employer to the employee, and the total amount of taxes deducted. If a person has had more than one employer during the previous year, he gets a withholding statement from each employer. For a worker earning under $5000, paying the tax is not complicated. On or before March 15th, he mails or brings the withholding statement to the nearest office of the Collector of Internal Revenue. If the amount withheld during the year equals the amount of taxes he should pay the

government, then he hears nothing further from the government. If the amount withheld is greater than what he should pay, he receives a tax-refund check. If the amount withheld is less than what he should pay, he must pay the balance. The worker whose wages are above $5000 has to fill out a tax form, but the process is essentially the same.

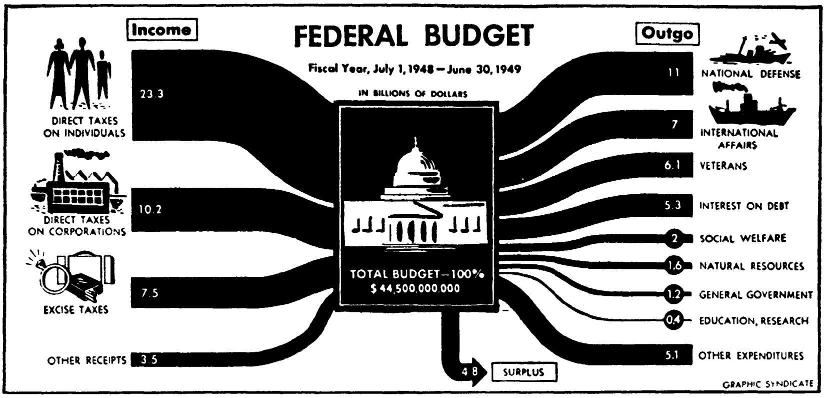
The withholding of taxes is used for wages, not for fees, rents, dividends, and other forms of income. Business and professional men, and people who receive income from investments, are required, therefore, to file quarterly reports of their earnings and estimates of taxes due. These taxes may be paid in a lump sum, or in installments with each quarterly estimate.

### Budget Procedures

Each year the government estimates its expenses and revenues for the year to follow. This annual estimate of expenditures and revenues for the following year is called the government's *budget*. The problem is somewhat different from that facing the family in the preparation of the family budget. The family has a fairly accurate idea of what its income will be; budget preparation is largely a matter of dividing known income among items of anticipated expense. The government, on the other hand, will generally start with a list of expenses; the problem is to provide revenue to meet these expenses.

Legislation authorizes and defines the services and activities of the government. When a government activity requires the expenditure of funds, there must be legislative authorization of the expenditure; such authorization is referred to as an *appropriation*. In the House of Representatives and the Senate there are Appropriation Committees, which study bills providing for appropriation of funds and make recommendations. They may recommend the amount provided for in the original bill, or a different amount. Having agreed to appropriate funds, Congress has the responsibility of legislating the means of raising them. In the federal government, a law creating a government service may simply state that the necessary funds be provided by the Treasury, or it may specify that revenues from a particular tax or bond issue be used. The Ways and Means Committee of the House of Representatives and the Finance Committee of the Senate are charged with the responsibility of analyzing bills for the raising of funds.

The task of preparing the annual budget is the responsibility of the executive branch of the government. The President secures from each department of government an estimate of its needs for the coming year. These estimates are turned over to the Budget Director, the federal official charged with preparing the budget to be submitted by the Presi-




**Federal revenue comes mostly from the income tax (a direct tax). Past and potential wars account for most of the expenses.**

dent. In consultation with the President, the cabinet, and the President's economic and political advisers, the Budget Director totals the expenses and lists the anticipated revenues. The expenses may include the costs of proposed legislation, and the revenues may include proposed taxing or borrowing operations.

The budget, as finally drawn, represents the program of the govern-

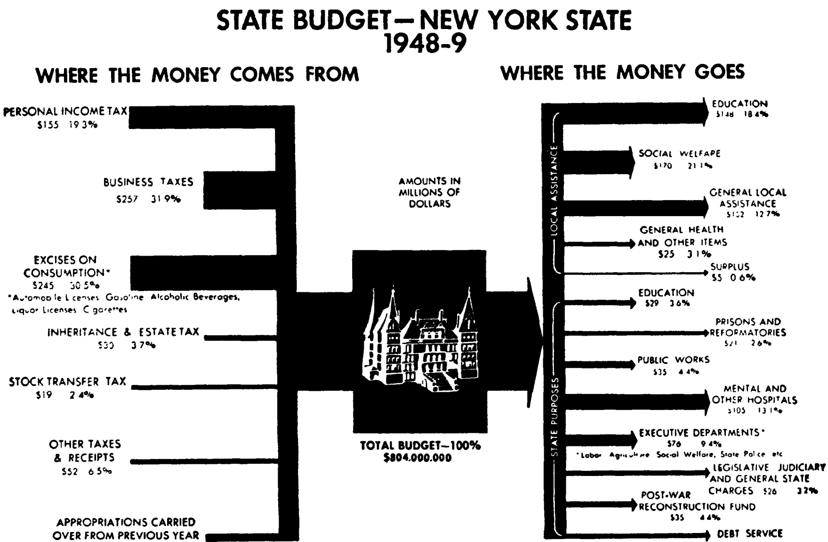



*Chart by Graphics Institute, N.Y.*

**Income taxes provide substantial revenues but excise taxes are important too. Note how a part of expenditures goes as "state aid" to local governments. (The thickness of the lines shows relative importance.)**

ment for the coming year. It is affected by the many pressures which the government feels from all sides. Government employees may want higher salaries; the various departments may wish to expand their activities; there may be a demand for public housing and power projects; and the farmers may seek government support for farm prices. These proposals may be fought by those who want the budget cut, so that taxes can be lowered. The budget tends, therefore, to be a compromise.

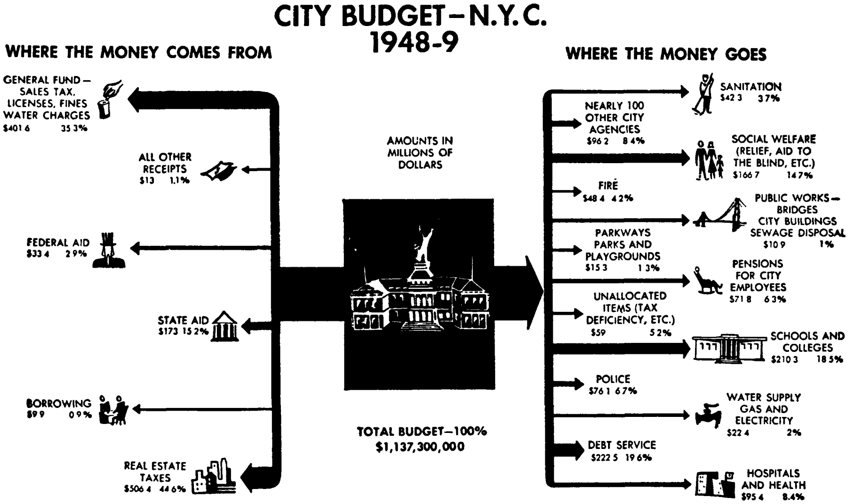



*Chart by Graphics Institute, N.Y.*

Note the importance of state and federal aid on the income side. Real-estate taxes are the chief source of income.

The President's budget goes to Congress in January. It provides for expenditure and income from July 1 to June 30 of the following year; this is the *fiscal period* in the federal government. Before 1950, Congress did not, however, adopt a budget, in the true sense of the word. The budget was not considered in Congress as a single, all-inclusive bill. Instead, Congress passed a series of appropriation and tax bills. Each appropriation bill authorized the expenditure of funds for specific purposes, and each tax bill authorized the government to levy certain taxes. These bills were treated like other legislative proposals. By the time all the appropriations and tax bills had gone through committees and the two Houses of Congress, the result was usually different from the budget submitted by the President. In 1950, however, Congress began to experiment with a single, all-inclusive appropriation bill.

In most of our state and local governments, the chief executive has more influence over the budget. The budget preparation is similar to

federal budgeting, but generally the budget is adopted as a whole, and is likely to be reasonably close to that recommended by the governor or the mayor.

Local governments are created by state charter. Therefore, in budget-making, they are controlled by state law and the provisions of their charters. It is common practice for the state to set a limit to the amount that a local government is permitted to raise by taxation and borrowing.

A government budget is an estimate. Actual expenditures and revenues for the year may vary considerably from the budget estimate. Generally it is possible to legislate for additional expense and additional taxation after the budget is adopted. Unanticipated events, such as drought, flood, unemployment, or war, may require extensive modification of financial plans. An anticipated surplus may turn into an actual deficit, or vice versa. Yet a budget, though tentative, is an important document. The proposed expenditures give a picture of the government's goals. The proposals for raising revenue provide a clue to its economic philosophy and sense of economic justice.

### Federal, State, and Local Budgets

Government budgets are complex. The diagrams on pages 600 and 601 offer a simplified comparison of a federal budget with a state and local budget. The budgets of New York State and New York City are used because of population and size, rather than because they are entirely typical. However, the sources of revenue and the types of expenditure shown are to be found in most state and local budgets, regardless of size.

Service on the public debt is an expense common to all. In the budgets shown, the federal government's expense for interest was about 14 percent of its total expenditure, compared to about 3½ percent for New York State, and almost 20 percent for New York City.

National defense, international affairs, veteran's payments, and interest on the public debt (most of it the result of war) accounted for about 66 percent of the federal budget. In the state and city budgets, the chief item was education, which took 22 percent of the state's budget and almost 19 percent of the city's budget.

Study of the budgets reveals a financial interrelationship among the governments. State expenditures are shown divided into two headings: "local assistance," which took almost 56 percent of the total, and "state purposes," which took the balance. In other words, over half of the state's expenditures were to assist the financing of local governments. This is shown on the income side of the city budget; New York City received 15 percent of income from the state, and 3 percent from the federal government. The federal government grants *federal aid*—that is,

financial assistance—to both state and local governments; the states grant *state aid* (financial assistance) to local governments.

Direct taxes paid by individuals and businesses, mainly income taxes, accounted for about three-fourths of federal revenue. The proportion in New York State was considerably smaller, and income taxes were not used by the city. Excise taxes, including the temporary "luxury taxes" of war years, although higher than usual, were not a major contributor of federal revenue. The state, on the other hand, gained approximately one-third of its income from excise taxes, and a city sales tax contributed substantially to the city's treasury. The chief source of tax revenue to the city, however, was the real-property tax, which does not appear as a source of revenue in the federal or state budgets.

## Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| appropriation | fiscal period | sales tax |
| assessed value | gift tax | social-security tax |
| budget | inheritance tax | state aid |
| estate tax | income tax | taxable income |
| excess-profits tax | payroll tax | tax base |
| excise tax | poll tax | tax rate |
| federal aid | property tax | withholding tax |

II Questions and Problems

1) In each of the following cases, tell the kind of payment due; and whether to federal, state, or local governments. (a) John goes for a ride, and buys ten gallons of gasoline. (b) At the filling station, he buys a package of cigarettes. (c) He "steps on the gas," and gets a ticket from a traffic officer. (d) The officer warns him that it's time to get new license plates for the car. (e) On arrival home, John finds a notice that a new sewer will be installed on the street on which he owns a house. (f) A few days later a relative dies and leaves John $50,000. (g) John goes into business and makes $8000 the first year. (h) John now decides to get married, and buys his fiancée a pearl necklace made in Paris.
2) List the factors which determine how much income tax an individual pays each year.
3) (a) What are the advantages in requiring the government to make an annual budget? (b) Explain how the making of the federal budget differs from the budget-making of most state and local governments.
4) Study the three budgets on pages 600 and 601. What are the important similarities and differences in these budgets?

5) (a) Explain why federal aid and state aid have become important in our system of public finance. (b) What are the chief forms of federal aid now being given to the states? (c) What forms of state aid does your local government receive?

III THINGS TO DO

1) Make a list of the taxes which you and your family have paid, directly and indirectly, during the past few weeks. Why is it difficult to know the total amount?
2) Compare the latest federal budget with the federal budget on page 600.
3) Compare the latest budgets of your own state and local governments with those of New York State and New York City, as to items included and amounts of money.
4) Read *U.S.A.: Measure of a Nation* (Twentieth Century Fund, 1949), Chapter 17, for a brief graphic summary of trends in government budgets.

# *LESSON* 78 PROBLEMS OF TAXATION

## THE TAX BURDEN

Although it is admitted that all must share in paying the common expenses of government, people do not enjoy paying taxes. The payment of taxes reduces the amount which the individual (or business enterprise) can spend. Will Johnstone's famous cartoon of the taxpayer, clad only in a barrel, has become a classic way of portraying taxation as depriving us of our income and wealth. Moreover, although the taxpayer may be resigned to the payment of taxes as a necessary evil, he is often suspicious that others are not carrying a fair share of the burden.

What is a just basis for determining who is to pay taxes, and how much each is to pay? One answer could be the *benefit principle of taxation.* This states that individuals should be taxed in proportion to the amount of benefit received from government services. Thus, taxes for the support of schools would be paid by those having children in school; taxes for the building and upkeep of roads would be paid by those making use of the roads. To some extent, the benefit principle is followed in levying taxes. Some states levy a gasoline tax, and try to devote its proceeds to road building; thus the automobile owner or truck owner pays for the costs of the roads which he uses. Social-security taxes on wages are paid only by those eligible to receive federal old-age pensions. The benefit principle is illustrated also by fees for licenses and permits and

by the *special assessments* which local governments levy. The special assessment is a charge to owners of real property for part of the cost of building sewers, streets, and other improvements which increase the value of the property.

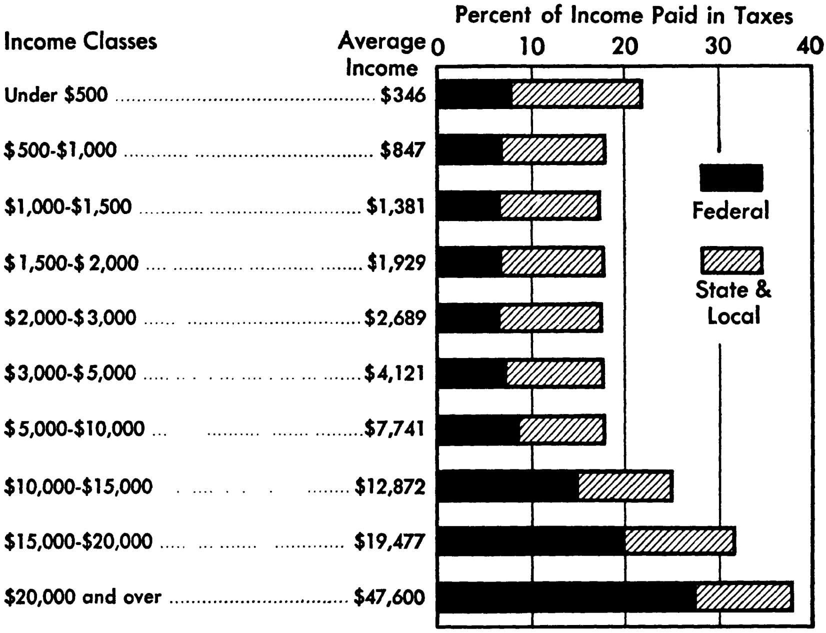
The benefit principle, however, cannot be applied fully. In the first place, it is impossible to measure exactly the amount of benefit a particular person or family receives from a given service or expenditure by the government. Police and fire protection, street cleaning, public-


*Will B. Johnstone in* N.Y. World-Telegram

health services, parks, national defense, and many other government services are maintained for the community as a whole. In the second place, basing taxes exclusively on the benefit principle would make many government services too expensive for the majority of the people. The wealthy would be able to provide the services for themselves, and the poor would have to do without them. Education, for example, would become the exclusive privilege of the well-to-do; hospital and health services would be a luxury. It would hardly pay to build playgrounds for the children of the relatively few families who could afford the admission prices which would be needed to put the playgrounds on a self-supporting basis.

It is therefore agreed that just distribution of tax burden requires that taxes be levied in accordance with ability to pay. The *ability-to-pay principle of taxation* states that those with greater income or wealth

## EFFECT OF THE AMERICAN TAX SYSTEM ON VARIOUS INCOME CLASSES 1939




The chart shows the burden of taxes as a proportion of income. Indirect as well as direct taxes are included. Indirect taxes made the tax burden as heavy for low-income families as for middle-income families. The progressive effects of income taxes were evident in income groups above $10,000. As a result of increases in tax rates during the 1940's, the tax system has become more progressive in the lower brackets. (Data from TNEC Monograph No. 20)

be taxed more heavily than those with lower income or wealth. This principle is applied in income taxes, real-property taxes, inheritance taxes, and many of our luxury taxes. It is most obviously not applied in the case of a poll tax, in which each individual pays a stated amount regardless of income or wealth.

The graph on this page shows the results of a study of the relationship of 1939 tax payments to the income of taxpayers. The length of the bar shows the percent of income which went for tax payments. The lowest income group, with incomes under $500 for the year, spent 21.9 percent for taxes, an average amount of a little over $75. Income groups ranging from $500 per year to $10,000 per year spent a somewhat lower percent on taxes, between 17 and 18 percent. For groups with incomes above $10,000, the taxes rose as income rose, both in number of dollars

paid and in percent of income. If the weight of the tax burden is measured by the number of dollars of taxes paid, then, according to the chart, the tax burden rose as income rose. However, if the tax burden is measured by the proportion of income paid in taxes, then it was greatest at the extremes, the families with incomes under $500, and those with incomes above $10,000.

### Direct and Indirect Taxes

The graph brings strikingly to attention a fact that is often overlooked; everybody pays taxes. Families with incomes of less than $500 paid over one-fifth of their income in taxes. Yet it is certain that these families were not aware of the fact that tax payments were taking so large a proportion of their incomes. The reason was that most of their taxes were hidden in the prices of goods and services which they bought.

When a person pays an income tax, inheritance tax, or poll tax to the government, he is well aware of the fact that he is paying a tax. Such taxes are called *direct taxes* because they are levied openly and directly upon the taxpayer. The government does not expect these taxes to be *shifted,* passed along, to other persons.

*Indirect taxes* are levied by the government with the expectation that those from whom the taxes are collected will shift the taxes to others. This occurs when the government places taxes upon the manufacture, sale, or importation of goods and services. The businessman who pays such taxes figures them as part of his costs and gets them back in his selling price. The tax is thus shifted from one seller to another, until it is ultimately paid by the final consumer of the goods or services which have been taxed. Excise taxes, sales taxes, and import duties are normally shifted in this way to the consumers.

The tax on real property is generally an indirect tax, since the landlord regards his taxes as one of the costs which must be covered by the rents he collects. If, however, a person occupies his own home, and has no tenants, the real-estate tax has the effect of a direct tax.

The person to whom an indirect tax is shifted sometimes knows that the purchase price includes a stated amount of tax. This may be true when the tax is on a product which must bear a tax or revenue stamp. The manufacturer of playing cards or tobacco products buys tax stamps from the government, affixes the stamps to the product, and includes the cost of the stamp in the selling price. The consumer also realizes that he is paying a tax when it is collected separately by the seller. This is so in the case of the federal tax on admissions, and sometimes in the case of a state or local sales tax. Where the retailer is required by law to quote the excise or sales tax separately from the price, the excise or sales tax may have the effect of a direct tax.

Frequently, however, the consumer is not aware that his purchase price includes tax payments; and rarely does he know exactly how large the tax payment is. Thus, indirect taxes included in the purchase price of goods or services, passed down to the final buyer by manufacturers and middlemen, are often called *hidden taxes.*

The burden of indirect taxes, many of them hidden, accounts for the larger part of the tax burden of lower income groups. Thus, over 20 percent of the income of families earning less than $500 in 1938–1939 went for indirect taxes, while slightly over 1 percent went for direct taxes. On the other hand, in families with incomes of over $20,000, only a little more than 5 percent of income went to pay indirect taxes, while direct taxes took almost 33 percent of income. State and local taxes tend to be indirect; federal taxes, direct. This fact can be confirmed by reëxamining the budgets compared in the previous lesson and noting that the personal-income tax, a direct tax, contributes a far larger proportion of federal revenue than of state or local revenue.

### Progressive, Proportional, and Regressive Taxation

The burden of a particular tax may best be measured by comparing the tax to the income of the taxpayer. If an individual with an income of $500 pays a tax of $50, and an individual with an income of $5000 also pays $50, then both are paying the same amount of tax. However, the tax burden is heavier for the person with the lower income. The man with $500 in income is paying 10 percent of it as tax, while the one with $5000 income is paying only 1 percent. A tax which takes a higher percent of low incomes than of high incomes is called a *regressive tax.* A regressive tax contradicts the principle of taxation in accordance with ability to pay.

Indirect taxes on goods and services tend to be regressive in effect. A sales tax of 2 percent on the purchase of a fifty-dollar suit costs every buyer the same amount, an additional dollar. But the lower the income of the purchaser, the greater is the burden of the tax. The medium-income family using the family car for a week-end excursion pays the same cent-and-a-half per gallon—the federal tax on gasoline—as does the millionaire being driven to his country estate. In proportion to income, the medium-income family is being taxed more heavily for gasoline than is the millionaire. It is, of course, true that the millionaire will pay more in taxes on furs and jewelry than the poor family, which buys none and therefore pays no taxes. These taxes are nevertheless regressive in nature, for they are based upon the amount of consumption and not upon the income of the payer.

A *proportional tax* is one which takes a constant, or equal, percent of income. Thus, if the family with an income of $500 pays $50 in tax and

the family with $5000 pays ten times as much, or $500, the tax rate in each case is the same, 10 percent. The closest approach to a proportional tax is the social-security tax; the percentage is the same for all workers who pay the tax. This tax is somewhat regressive, however, because the tax applies only to wages up to a specified limit. Workers earning more than this limit are therefore paying a slightly lower percent of their total income.

A *progressive tax* is one which takes a larger proportion, or percent, of the income as the income increases. For example, the individual with an income of $500 pays $50, or 10 percent, and the person with an income of $5000 pays $700, or 14 percent. The federal income tax is an example of a progressive tax. The table which follows was computed from the schedule of federal tax rates applied to 1949 incomes:

| *Taxable Income* | *Amount of Tax* | *Tax as Percent of Income* | *Spendable Income* |
|---|---|---|---|
| $2000 | $400 | 20 | $1600 |
| $20,000 | $7260 | 36.3 | $12,740 |
| $200,000 | $156,820 | 78.4 | $43,180 |
| $2,000,000 | $1,794,820 | 89.7 | $205,180 |

It will be observed that in this table each succeeding amount of taxable income is ten times as great as the preceding one. The amount of taxes, shown in the second column, increases by more than ten times for each step; for example, $7260, the tax on $20,000, is over 18 times as great as $400, the tax on $2000. This progressive increase in taxation is shown in the third column as an increasing percent of tax to taxable income. The final column shows the amount of income retained by the taxpayer. This amount increases at a much slower rate than taxable income.

### Problems of Progressive Taxation

Why have we not used a proportional, rather than a progressive, income tax? The answer lies in Engel's Law, which you studied in Lesson 10. You learned that as family income increases, the percentage of the income spent for necessities declines, and the percentage for luxuries and savings increases. This means that taxes paid by the low-income family cut down the amount of necessities which the family can buy. Taxes paid by high-income families can come mainly out of their luxuries and savings. If all families were taxed at the same rate, the sacrifice for the low-income families would be relatively much greater than for the upper-income families.

Some groups have suggested the gradual elimination of indirect taxes, and the financing of government entirely by means of a progressive income tax. They argue, first of all, that the progressive income tax

is the fairest kind of tax, based on ability to pay. Indirect taxes bear most heavily on the lower-income groups; removing such taxes will increase the real income of these groups. The fact that regressive taxes are often hidden is also used as an argument for discontinuing their use. Every citizen, it is said, should be fully aware of how much he is paying in taxes. He will then be more likely to be interested in the revenues and expenditures of his government.

The opposition to complete dependence on a progressive income tax is based on several points. If all indirect taxes were removed, the loss of revenue would undoubtedly have to be offset by increasing the income-tax rates. High income-tax rates, in the opinion of some groups, may lessen the effectiveness of the free-enterprise system, by reducing private saving and investment, most of which is done by middle-income and high-income groups. Moreover, there may be little inducement to businessmen to expand their businesses, or to start new enterprises. If private saving and investment shrink, it is argued, there will be more dependence upon the government to supply capital for needed enterprises, and a trend toward socialistic control of business.

Another problem which arises in connection with progressive taxation is the fact that the revenues from the income tax are unstable. In good times the revenues may be greater than planned, producing surpluses which may be wasted in needless expenditures. When times turn bad, the revenue from the income tax shrinks, at the very time when more funds are needed for relief, public works, and subsidies. Experience has shown that the returns from real-estate, sales, and excise taxes fluctuate less. It is felt that mixing the various kinds of taxes keeps public revenues on a more even level.

### Considerations in Tax Policy

In determining which taxes to levy and how to levy them, certain considerations must be kept in mind. The first question to be raised is, "Will the tax yield revenues which are large enough?" Experience has shown that, whatever tax is used, the amount that can be raised depends upon the size of the national income. If business conditions are bad, and incomes and employment are low, taxes will raise less in revenue than under conditions of good business and high income. Therefore, a second consideration of prime importance is, "What is the effect of the tax on business enterprise and economic conditions?" Should a given tax provoke a deflationary trend and a depression in business activity, the tax yield may be considerably lower than anticipated.

A third question of importance, also related to the revenue yielded by a tax, is, "How difficult and how costly will it be to collect?" If a tax law is easy to evade, the revenue resulting from the tax will be less than

expected. If expensive procedures and policing are necessary to secure adequate enforcement, the net revenue from tax collections will be considerably reduced. Furthermore, a tax which invites evasion and requires too much policing may cause injustice in distribution of the tax burden, make for excessive interference with individual liberties, and provoke considerable resentment.

A fourth question is, "How just is the distribution of the tax burden?" If the principle on which the tax is levied is the benefit principle, there must be means of ascertaining that the tax burden is actually in accordance with benefit received. If the aim is to tax in accordance with ability to pay, the tax rates should be graduated in order to provide for progressive taxation, and regressive features must be avoided.

A fifth consideration is, "Are taxes uniform for the country as a whole?" If taxes vary from one locality to another, then the tax burden depends upon where one happens to be, rather than on ability to pay. Besides the federal government, forty-eight states and many thousands of cities, towns and villages levy taxes, independently of one another. Income taxes and sales taxes, particularly, vary from one state to another. State and city administrations find it difficult to finance needed activities, because they are afraid that higher taxes will drive wealthy residents and large business firms to places where taxes are lower.

A final consideration is, "To what extent is the purpose of the tax some measure of social control, rather than a source of revenue?" The federal tariff is not aimed at producing large revenue, but at discouraging foreign competition. The excise taxes on tobacco, liquor, and playing cards are also means of limiting consumption of goods considered by some to be unnecessary and undesirable. The inheritance and estate taxes are means of limiting the accumulation of wealth.

An actual tax measure is a compromise among all these varying considerations. It will depend upon the economic conditions facing the nation at the time, and upon the political and social sentiments which prevail. It will also depend upon the volume of government expenditure which is regarded as necessary and desirable. Another consideration will be whether the government wishes, and is able, to use borrowing as an alternative to taxation.

## Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

- ability-to-pay principle
- benefit principle
- direct tax
- hidden tax
- indirect tax
- progressive tax
- proportional tax
- regressive tax
- shifting of tax
- special assessment

## II Questions and Problems

1) The American colonists fought against England in 1776 because they resented taxes. Why did they give their new national government of 1789 the power to tax?
2) Write a paragraph answering the question, "Who pays taxes"?
3) A magazine once published an article entitled, "Taxes: How Much Do You Really Pay"? What was the meaning of the title?
4) Write a paragraph summarizing the chart on page 606.
5) (a) Explain and give examples of the benefit theory of taxation and the ability-to-pay principle. (b) List the arguments for and against each theory.
6) The famous French finance minister, Colbert, in the 17th century, said, "Taxation is the art of plucking the goose in such a way as to cause the least squawk." What did Colbert mean? What kind of taxes did he favor using? What is your opinion of his statement?
7) (a) Explain the basis for distinguishing among a regressive, a proportional, and a progressive tax. (b) List arguments for and against progressive taxation.
8) (a) What is meant by "Robin Hood taxation"? (b) What arguments can you give for and against this approach to public finance?
9) (a) How has the industrial revolution made it possible to shift from regressive to progressive taxes during the past hundred years? (b) Has this change been a good or bad one? Why?
10) A prominent taxpayer organization has advocated that the Constitution be amended to put a limit of 25 percent on income-tax rates. Explain why you would favor or oppose this proposal.
11) There has been much agitation in recent years for the elimination of regressive taxes, so that the tax system would be entirely progressive. What would be the benefits of such a change? What would be the disadvantages?
12) "The United States is being forced toward socialism by a tax revolution of far-reaching consequences." (Advertisement, *Herald Tribune*, New York, March 12, 1948.) (a) What is meant by "tax revolution"? (b) How could taxes be used to force this country toward socialism? (c) Explain why you agree or disagree with the statement.

## III Things To Do

1) Report on taxpayer organizations in your community. Secure their literature, and summarize their main proposals.
2) Make a collection of cartoons about the problems of the taxpayer. Better still, draw a cartoon expressing your own views on the matter.
3) Organize the class as a congressional committee on taxation. Work out a program for whatever improvement of the tax system you may decide is needed.

# LESSON 79 PROBLEMS OF FISCAL POLICY

### Budgets and Debt

Public finance has been an issue of major importance in almost every political campaign of recent years. There has been vigorous controversy over the effects upon the economy of heavy spending, high rates of taxation, and borrowing.

The annual expenditures of the federal government for the years 1914 to 1916 averaged about 750 million dollars, and the federal debt was slightly over 1 billion dollars. The new federal income tax, established in 1916, following the ratification of the Sixteenth Amendment, provided for tax rates which, compared to present rates, were extremely low.

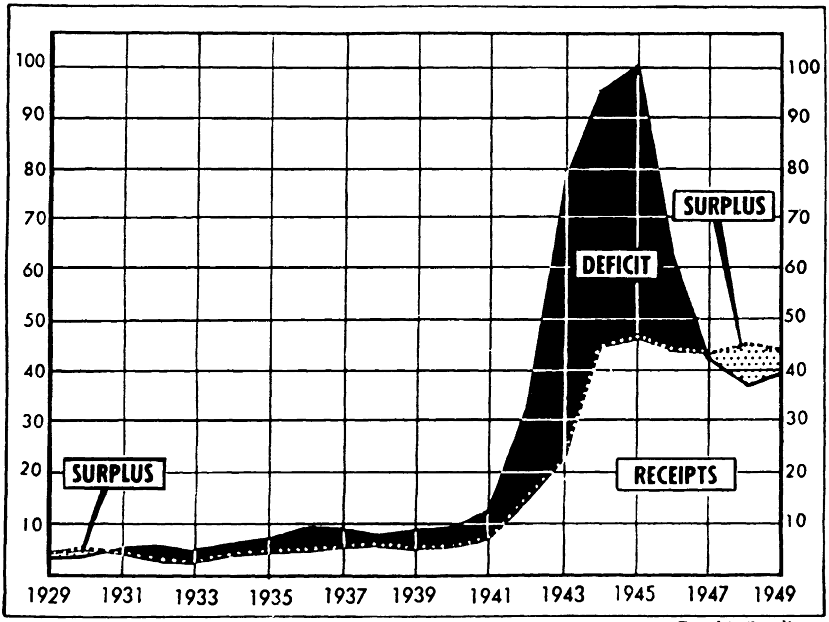
World War I revolutionized standards of measurements in public finance. People became accustomed to thinking in terms of billions of dollars of expenditure and debt. In 1918 and 1919, the federal government spent tens of billions for the war, and was left with a debt of nearly 26 billions. The extraordinary prosperity in the 1920's, however, made it relatively easy for the government to meet these obligations. Government expenditures were stabilized at about three billion dollars annually; while federal revenues were large enough to produce annual surpluses of from one-half to one billion dollars per year. Between 1920 and 1930 the government paid off ten billions of the federal debt, while at the same time reducing income-tax rates.

This happy situation was ended by the severe depression which lasted through most of the decade of the 1930's. The financial burden of relief payments, public-works projects, and aid to farming and industry boosted federal expenditures to new peacetime heights. The annual budget ranged from 7 to 9 billions. The decline in national income sharply reduced the ability to increase federal revenues to meet expanding expense. The result was deficits of from 2 to 4 billions annually. By the later 1930's the federal debt had risen to about 40 billions.

Even before our entry into World War II, the adoption of a defense program, a peacetime draft, and lend-lease expanded the federal budget. For the war years, 1942–1946, the government's expenditures added up to nearly 400 billion dollars. Although the wartime prosperity enabled the government to collect large amounts of taxes, annual deficits were over 50 billions for three consecutive years. At the end of the fiscal year of 1946, the federal debt had reached a new peak of 270 billions.

## TREND OF THE FEDERAL BUDGET

IN BILLIONS OF DOLLARS




*Graphic Syndicate*

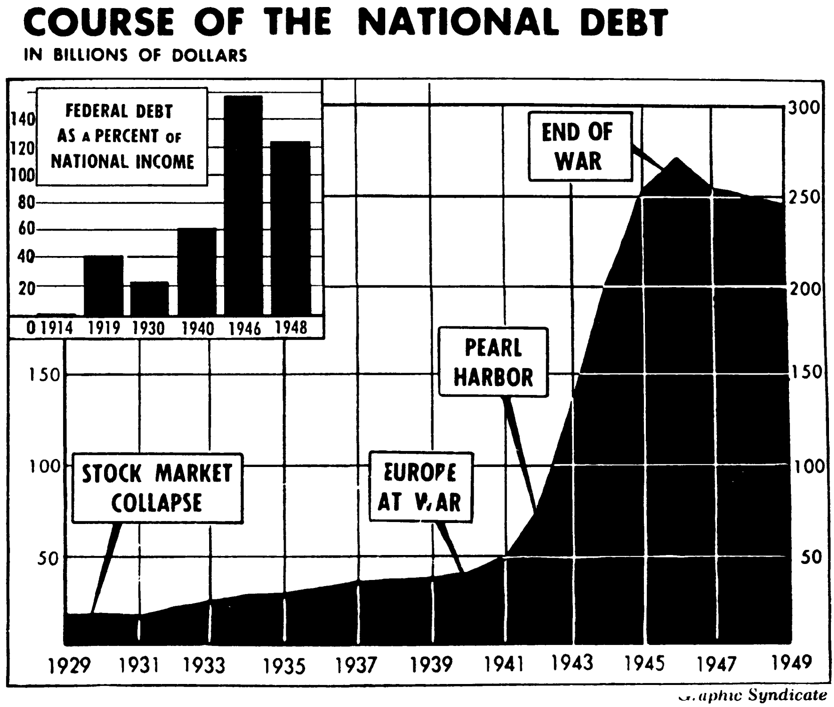
During most of the past 20 years the federal government spent beyond the tax revenues; hence there have been deficits. This was caused by the depression during the thirties and the war during the forties.

With high levels of production and national income continuing into the postwar period, tax collections remained at a high level. At the same time, war expenditures dropped. In 1947 and 1948, for the first time since 1930, the federal budget showed a surplus rather than a deficit. The process of paying off the huge debt was begun. The development of strained international relations, involving the need for large expenditures for defense and for assistance to Western European nations, prevented the continuation of the drop in expenditure. In addition, the demands for expanded welfare programs in housing and social security created the possibility of further deficits and expansion of debt.

The charts on these pages show the course of the federal budget and debt from 1929 to 1949. The connection between budgetary deficits and debt is clearly shown.

### The Controversy over Government Spending

In 1947 and 1948 the federal budget had a surplus of revenues over expenditures. This touched off a controversy as to the relative merits




The deficits shown in the graph on the opposite page were made up by borrowing; hence the mounting public debt. The bar chart in the upper left-hand corner shows that the public debt has grown in relation to national income as well as in total number of dollars.

of lowering tax rates, paying off the debt, or increasing expenditures to permit expanded government services.

Large federal budgets are opposed on several grounds. Opponents of spending argue that much government expenditure is based on political pressure rather than genuine need. They argue, for example, that the weight of votes cast by farmers or workers, rather than the degree of need, determines the volume of spending by government. They point to multiplication of federal agencies and personnel as evidence of the wasteful and uneconomical spending procedures of government.

Many critics of government spending are in thorough disagreement with the purposes for which the money is spent. They believe that expenditure for such purposes as aid to farmers, relief of the unemployed, and the establishment or support of government enterprises like TVA and public housing, are not only expensive but also a danger to the system of private enterprise. Money spent by government is money distributed as incomes to those who receive it. More and more govern-

ment spending, to provide a greater proportion of conveniences, services, and security, the critics say, will make the people lean more heavily on the government. It will make the role of the government as producer more important, and the role of the individual less so. This, the critics argue, will lead the country into a socialistic system in which the government, rather than the individual, will play the central part.

Defenders of the expansion of government spending argue that this expansion has been necessary to preserve the economic system. The fact is, they remind critics, that economic problems required government spending, rather than that government spending created economic problems. The huge spending of the 1930's was the product of a world-wide depression. Unemployment, low prices, strikes by workers and farmers, the lowest national income in years, thousands of enterprises failing or on the edge of failure—these were concrete evidences of the need for emergency action by the government, welcomed by all at the time of crisis. In the opinion of the supporters of government spending, the deficits incurred during the depression years were a means of preserving economic individualism rather than destroying it. They point to the development of communism and fascism in other countries where the government could not, or would not, take steps within a democratic framework to provide essential services. Moreover, the greatest part of government spending leading to deficit and debt has been the result of war. Thus, the deficits of the last twenty years have been almost entirely the result of emergency in peacetime or wartime.

Some advocates of more government spending go beyond apologizing for it as an emergency measure. They argue that government spending is a vital link in a program to keep the economy on a stable level. They say that the level of business activity depends upon the amount of money spent by consumers for consumers' goods, and on the amount invested by businessmen in capital goods, such as plants and machines. A slackening of consumer buying and of investment in capital goods causes a decline in production and employment. Thus, say advocates of government spending, when private individuals and industry are beginning to spend less, the government should spend more for public projects. This public spending will compensate for the decline of private spending and will help to keep economic activity at a stable level. At the same time the government should reduce taxes, in order to leave more spendable income in the hands of the public. The government would therefore have to borrow much of the money for its expenditures. During prosperous times, however, government spending would be reduced, taxes would be raised, and the national debt paid off. This theory that the government, through its spending and taxing policies, should compensate for failures of individual buying and investment, is often referred to as the theory of *compensatory spending*.

SPENDING, TAXES, AND DEBT

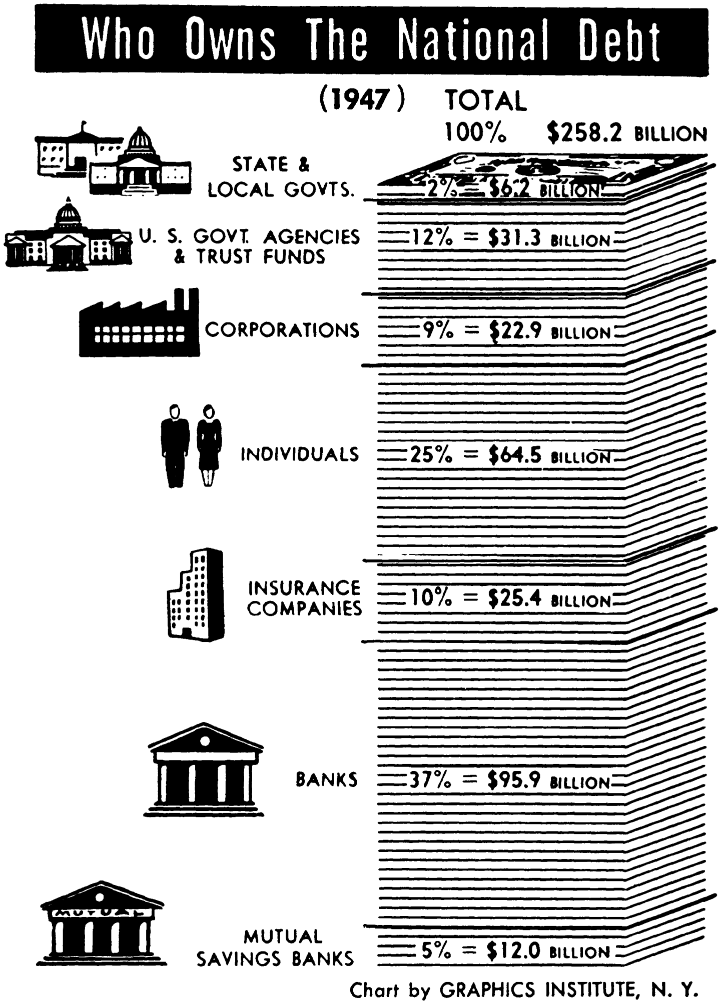
The movement for reduction of government spending has spread in recent years, as more people have become subject to taxation and as tax rates have risen. More of the low- and medium-income families pay income taxes now than twenty or thirty years ago. The rates have become steeper. The withholding of taxes from wages has been a constant reminder of the fact of payment of taxes. In addition, sales taxes, excise taxes, and luxury taxes have become more common.

Taxation reduces—at least temporarily—the spending and investing power of individuals who are taxed. It increases the spending and investing power of the government. As the government spends and invests, it increases the incomes of those to whom it pays money, and of those who benefit indirectly from government projects. Taxation is a means by which the national income is redistributed.

Some people feel that the tax burden has become too heavy. They remind us that federal taxation takes from private individuals and corporations one-fifth of the national income. This discourages private enterprise and investment. Why, they ask, should individuals take business risks, and build up large incomes, when tax rates are so high as to limit the rewards for risk and initiative?

Those who defend the high tax rates say that government taxation and spending does more than take away part of the national income and redistribute it to others. Taxing and spending help to increase the national income, by putting to work money which otherwise might remain idle as uninvested savings. When the government gets this money through taxation, and then spends it, many industries are stimulated. The steel industry, for example, in order to fill government orders for steel, must pay wages and buy coal and other materials. The industries which supply goods and services to the steel industry, in turn, pay wages and buy still other materials. Thus the original government expenditure for steel stimulates a considerable amount of production throughout the economy. The increased wage payments encourage consumer buying and stimulate production in other industries. Hence, a million dollars of national income, taken and spent by government, may result in the creation of much more than a million dollars of national income. Even those who are being taxed may gain, as they get their share of the larger national income.

Opponents of this theory of the multiplied effect of government spending retort that the same increase of national income would result from private investment, if such private investment were not discouraged by heavy taxation. These people also point to the staggering size of the federal debt as an element of danger to our economic and political stability. They charge that spendthrift policies today will be the basis for a back-breaking burden of debt for future generations. Interest




Most of the federal debt is owed to individuals and enterprises in this country. Federal bonds have become a cornerstone of our entire credit system. Note that 12% was owed to subdivisions of the government itself.

payments on the federal debt amount to about five billions. This is a fixed charge, which can be reduced substantially only by payment of the debt. Should tax revenues in future years decline, the burden of the public-debt service would still remain. Future generations will have to pay the cost of services received long in the past, and will be unable to pay for new services. Should revenues be small, it would be necessary to borrow still more. Difficulty in balancing the budget will reduce the confidence of investors in government securities, the rate of interest

paid will rise, and the interest burden will become greater. Investors, losing confidence, will sell government securities and invest in other channels or in foreign countries. The credit of the government will be undermined, its money will lose value, and the entire economic structure will be in danger.

This view is regarded by others as unduly pessimistic and exaggerated. The debt burden, it is felt, should be measured in comparison to the national income. The ability of the government to meet its obligations depends on its ability to raise enough tax revenues; this in turn depends on the national income. In 1949 the interest on the public debt was between 2 and 3 percent of the national income. Government securities were regarded as a good investment; they were easily sold to investors even though they carried very low interest rates. Although the public debt at the time was over 250 billions, the highest in history, fears for the credit of the country were not evident among the nation's investors.

It is the contention of some economists that a large public debt is not in itself a dangerous factor. As long as purchasers of government bonds receive interest, and find the investment profitable and secure, the problem of repayment is not a major one. The government can meet maturing obligations by *refunding,* that is, by issuing new bonds to substitute for those coming due. The debt of the government is actually an important form of savings and income for citizens of the nation. This is shown on the chart on the opposite page.

It will be noted that 12 percent of the federal debt was owed to agencies of the government itself, and another 2 percent to state and local governments; 25 percent was owed to individuals; and the balance to corporations and financial institutions, which were owned by millions of stockholders, policyholders, and bank depositors. These direct and indirect holders of government obligations have found them to be a secure investment. The stability of the national finances has been a product of general economic progress, and of the faith of the people in their government.

## Exercises and Activities

### I Dictionary of Economic Terms

compensatory spending

refunding a debt

### II Questions and Problems

1) Summarize the changes in the national government's debt from 1916 to 1946, and explain the reasons for these changes.

2) In parallel columns list the reasons for and against paying off the national debt as rapidly as possible.
3) (a) Explain how a policy of "compensatory spending" would operate if it were adopted by the national government. (b) Why has this policy also been called "flexible financing"? (c) During the 1930's the term "deficit financing" was used. Why?
4) "Debt management . . . is partly a question of our philosophy of government—of what to expect from the central government, and what should be left to local government and to individual initiative and self-reliance." (*Our National Debt,* Committee on Public Debt Policy, Harcourt, Brace, 1949, p. 164.) Show how differences of opinion about philosophy of government can lead to differences of opinion as to what should be done about the public debt.
5) Explain one or more of these statements, and give reasons for agreeing or disagreeing with the statement. (a) Government spending must be used to prevent depressions. (b) Government spending will bring socialism and dictatorship. (c) Government spending has become an important factor in economic progress. (d) Taxes are hindering economic progress. (e) Government deficits are thefts from generations yet to be born.
6) Write a letter, such as you might send to your Congressman, telling him what policy you think should be followed regarding government spending and taxation, and the public debt.

III THINGS TO DO

1) Interview a few people about their opinions on the matter of government spending, and ask for concrete suggestions on how to limit government spending.
2) Bring in clippings from newspapers and magazines, which illustrate the varying viewpoints about taxation and public debt. Consult the *Readers' Guide to Periodical Literature* for current articles in this field and report to the class.
3) Advanced students may want to consult recently published texts on public finance and read selected portions.

# *UNIT* 14

## BUSINESS CYCLES


*80* THE NATURE OF THE BUSINESS CYCLE

*81* CAUSES OF THE BUSINESS CYCLE

*82* COMBATING CONTRACTION: THE NEW DEAL

*83* DIRECTING WARTIME EXPANSION

*84* PROBLEMS IN CONTROLLING THE CYCLE

# LESSON 80 THE NATURE OF THE BUSINESS CYCLE

## Business Fluctuations

Business conditions, like the weather, are subject to continuous change or fluctuation. Some fluctuations are normal, regular, and predictable, and can be anticipated by the businessman. The restaurant proprietor knows that at certain times of the day he will find his tables unoccupied, and he adjusts his workers' hours accordingly. The farmer knows that his production will be limited to a particular growing season. Most businesses have a regular pattern, or rhythm, of busy and slow periods during the day, week, or year; and operations can be planned accordingly.

Some fluctuations, however, are not so easily predictable. These are the fluctuations that the businessman fears most, for he cannot easily prepare for them in advance. It is the unpredictable fluctuation that brings risk into business enterprise.

There are four major types of business fluctuation: *seasonal, secular, cyclical,* and *random.* The first three have already been discussed (see Lesson 60) in connection with the problem of unemployment.

Seasonal fluctuations occur regularly during the same period each year, as in the fur and coal industries. They are, by and large, predictable, and the businessman can adapt his operations to offset their effects.

Secular fluctuations are gradual over a long period of time; an example would be the gradual increase in the proportion of the population made up of older age groups. Adjustments to these changes can often be made fairly well, since the changes take a long time to have their full effects, and are to some degree predictable.

Random fluctuations are irregular in their occurrence. They seem almost accidental, and are therefore the least predictable. A hailstorm, drought, flood, insect migration, or frost may ruin a farmer's chance for income. A change in style; a new invention; special legislation freezing rents, wages, or prices; and a revolution or a war in another country are examples of events producing random fluctuations in business.

As man's knowledge increases, the possibility grows, however, of eliminating random fluctuations based on natural occurrences. Prediction of storms, floods, droughts, and so forth becomes more accurate; new types of seed and crop are developed to eliminate danger of frost,

drought, or insect pest; new technology teaches us how to reduce the losses and danger when the event occurs. Moreover, we can often protect ourselves against losses from some random events through the purchase of insurance policies covering damage from weather, fire, theft, and other causes.

Cyclical fluctuations are the wave-like alternating periods of rise and fall in business activity as a whole. These fluctuations are most important and most difficult to understand. Although we cannot predict when these changes will take place, we are fairly safe in predicting, on the basis of past events, that they will take place. The chart opposite gives proof that cyclical fluctuations have been a feature of our economic world since our beginning as a nation.

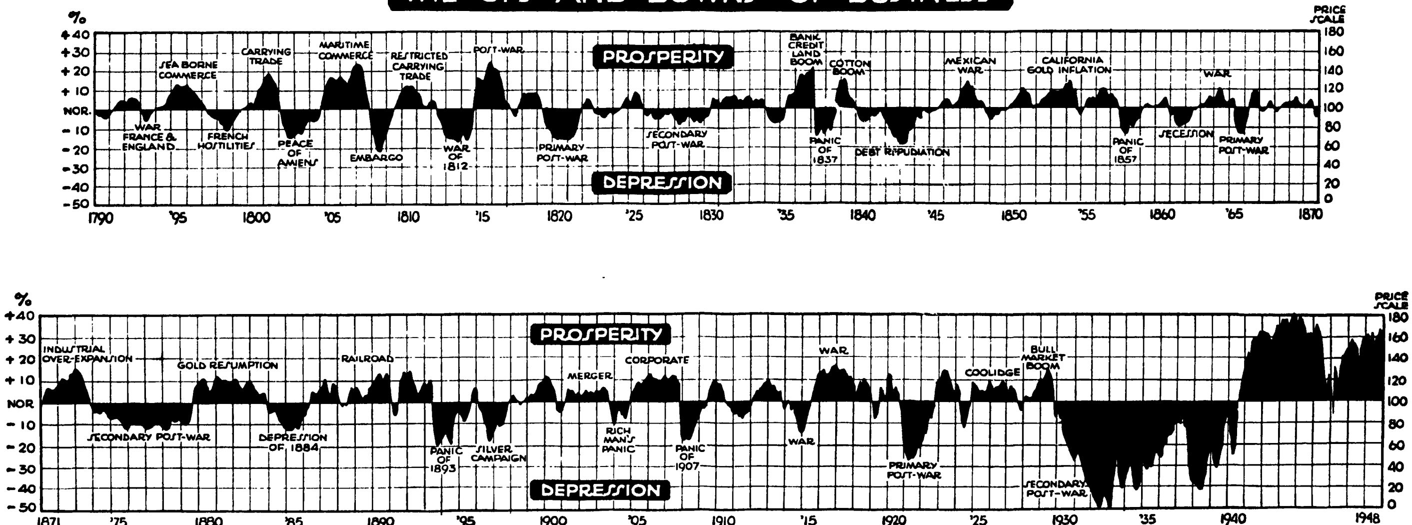
### Phases of the Business Cycle

The business cycle is one complete movement of business activity through a period of *expansion* and a period of *contraction*. Expansion refers to the growth of business activity; contraction to the decline of business activity. Expansion and contraction are the two major phases, or parts, of the business cycle. Where one phase changes to the other, we have the turning points. Where expansion reaches its highest point and contraction begins, we have the *upper turning point;* where contraction reaches its lowest point and expansion begins, we have the *lower turning point.* A business cycle, therefore, consists of an expansion phase building up to the upper turning point, followed by a period of contraction and the lower turning point, which ushers in a new cycle. The illustration on page 626 shows the phases of the business cycle and the terms commonly used to identify its parts.

Cyclical fluctuations are uneven. This is shown in the uneven duration of the cycles. From 1855 to 1938, the average length of a full cycle was just under 4 years, but the length of each of the various cycles varied from 2½ to 8 years. Within the cycles, the length of periods of expansion varied from 9 months to over 4 years; the length of periods of contraction varied from 8 months to 5½ years. (See graph on p. 627.)

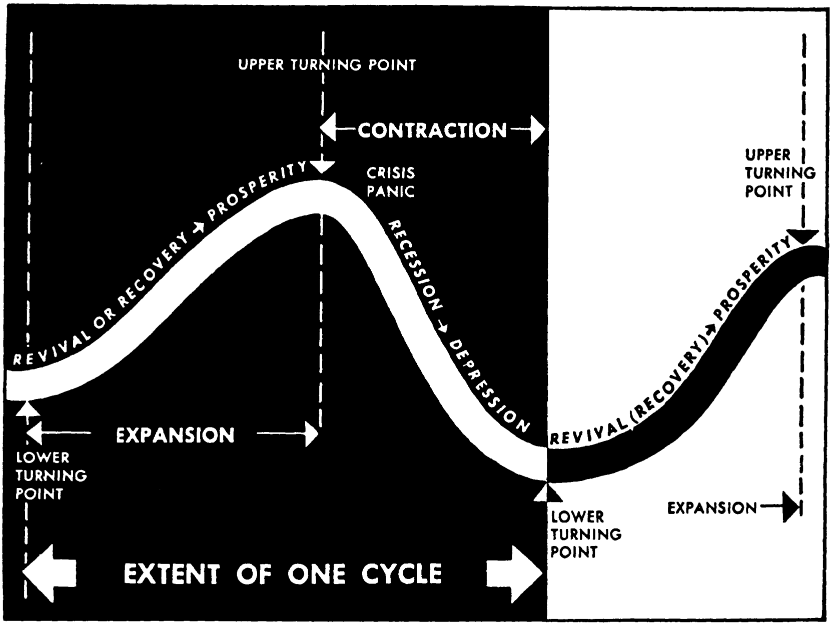
Neither is the degree of fluctuation uniform; there is great variation in the amount of expansion and the amount of contraction. There is also variation in the amount of fluctuation in specific economic factors —wages, production, prices. They vary considerably from one another and in relation to the general trend of a cycle. Expansion of one factor and contraction of another may go on at the same time. Only one thing is perfectly regular about the business cycle, and that is the fact that there is a recurring cycle; periods of expansion have been regularly followed by periods of contraction, which in turn have been regularly followed by periods of expansion.

# THE UPS AND DOWNS OF BUSINESS




*Adapted from chart by the late General Leonard P. Ayres, Cleveland Trust Company*

**A glance reveals that we have had alternating periods of good and bad business conditions throughout our history. It shows too that the fluctuations have not been equal in length or depth.**




**TERMINOLOGY OF THE BUSINESS CYCLE**

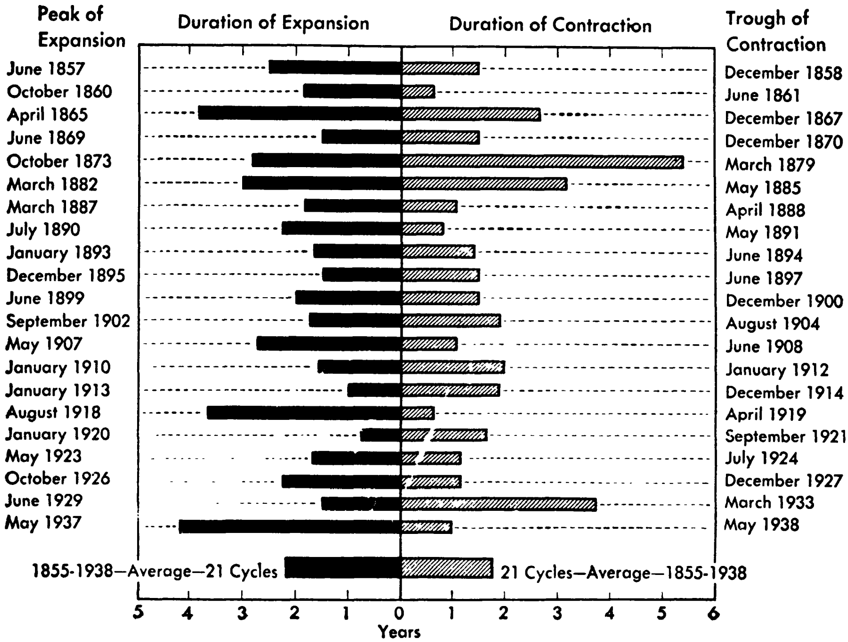
Chart by GRAPHICS INSTITUTE, N. Y.

### The Expansion Phase

The expansion phase is the period of progress toward fuller and fuller utilization of the factors of production. It means fuller use of facilities already in existence, as well as the creation of new productive facilities.

In its early stages, expansion may be called *revival* or *recovery,* in recognition of the fact that the expansion follows a prior period of contraction. Businessmen are increasing their production of goods and services. They are working their factories, mines, and farms closer to capacity. Some are undertaking additions to their plants, building new ones, modernizing the old ones, and adding new machinery. An increase in the capacity to produce is therefore taking place. The rate of increase in production in all lines is not necessarily the same. New industries—automobiles, radio, television, and plastics in recent times—may expand faster than older industries. The outpouring of goods consists of raw materials, perishable consumers' goods, durable consumers' goods, machinery, construction of buildings for residential and production purposes, and public works. In general, because of the tendency to expand production capacity and build new factories and facilities, the

**DURATION OF AMERICAN CYCLES, 1855-1938**




**Read this graph from the center to the right for the number of years of contraction, to the left for the number of years of expansion. The average full cycle during this period was about four years. (Data from National Bureau of Economic Research)**

machine industries, construction, and other "heavy industries" feel the effects of the general upsurge more fully.

This increased output is interconnected. An increased output of automobiles means an increased production of steel and other metals, rubber, textiles, and many other products. More automobiles mean more gasoline; more gasoline means more pipelines, trucks, drilling and refining equipment; and so forth. More roads are needed; these require still more machinery, cement, lumber, gravel, and steel for bridges. One increase in production multiplies the production of other products, and this new increase, in turn, may cause further increase in the production of the original product. Thus, during expansion, production tends to spiral upward to continuously higher levels.

Expansion in production is related to expansion of demand. Increasing production means increased payments of wages and other incomes. Hence, the total of purchasing power tends to swell even more rapidly than the output of goods. Rising demand may cause prices to rise.

Profit-making possibilities become good. As production rises closer to capacity, cost per unit tends to decline, and the combination of rising prices and lowered unit costs makes for increased profits. Businessmen are encouraged to continue with production and income payments, and the prevailing wind of optimism blows with increasing intensity.

Expansion means jobs for workers and a decline in unemployment. Even during expansion there are some who are unemployed—those who are seasonally unemployed, and those who lose their jobs because of the innovations and inventions introduced during expansion. However, those who were laid off during the previous period of low business activity are reëmployed, and cyclical unemployment is on the decline.

Expansion is usually a period of rising prices. As long as output continues to increase, there is no great danger of prices running away and mounting into a spiral of inflation. However, as the economy approaches its maximum capacity to produce, there is mounting danger that inflation will become severe and "runaway."

Expansion is the period of increased savings, investment, and speculation. As profits rise, the values of income-producing property—real estate, mortgages, securities—also rise. Banks, loaded with reserves, and encouraged by higher valuations on property used as security for loans, are willing and able to extend credit. The expansion of credit swells the stream of funds going into the purchase of consumers' goods and capital goods. Rising prices create opportunities for speculative profits, from buying goods and property, and reselling at higher prices.

More buying means more selling and production; more production means more income paid out, greater demand, and still more buying. So the tempo of economic activity mounts and mounts. This is the period of *prosperity,* the period when economic activity has reached a high level, when business optimism is great. Expansion is cumulative; each increase in activity induces still more increases. Then, alas, the turning point!

### The Upper Turning Point

The crest of expansion and the beginning of contraction is called the "upper turning point." Sometimes it goes unnoticed by all except a few careful students of economic statistics. Sometimes the turning point seems to be started by a random event, such as the outbreak of war or the prospect of its termination, the election of an administration thought to be hostile to business, or the failure of a large bank. Sometimes, after the turning point has actually been reached, attention is directed to it by a dramatic event, such as a decline in security values, a bank failure, a sudden liquidation of inventories. Hence this beginning of the contraction period is often called a *crisis.* This becomes a *panic* when it

degenerates into widespread fear, bank failures, and sudden losses. The term appears in our history books: the Panic of 1837, the Panic of 1907.

### The Contraction Phase

The contraction phase is the period of decline to a lower utilization of the factors of production. It means that the existing facilities are used at a lower percent of capacity, and that many are closed down entirely. Moreover, the production of new plant and equipment declines.

Production of goods and services declines. In industries characterized by a great deal of competition, output may continue at high levels, accompanied by drastic price cutting, until bankruptcy and the elimination of producers cut total output. In industries where some kind of monopolistic conditions exists, the reduction in volume of production may be more immediate. The demand for new building and capital goods declines; so that the industries feeling the brunt of the decline most are the construction industries and the heavy industries, which previously had felt the stimulus of expansion most.

Each decline in production makes its weight felt throughout the economic system. Curtailment of manufacturing means a reduction in the demand for raw materials; reduction in shipments of raw materials plays havoc with the transportation industries. As volume of output drops to a lower and lower percentage of capacity, costs per unit rise, profit becomes lower, and eventually there are losses instead of profits.

Demand is reduced, because the drop in production cuts down the income paid out in the form of wages, salaries, dividends, rents, and interest. Unemployment means a stoppage of earnings for large numbers of workers, and cyclical unemployment becomes a reality. Although demand may be choked off by the absence of income, basic needs for goods and services continue. While factories are closed, and machines and men are idle, starvation and suffering increase, and the paradox of want in the midst of potential plenty becomes most glaring.

The contraction phase is largely a period of deflation. Prices fall. In competitive industries, cutthroat price cutting becomes the order of the day. Values fall. If reduced income makes necessary the sale of property purchased during the prosperous years, only a fraction of the purchase price will be realized. Banks may find that the values of the assets which they hold as security for loans have dropped below the amounts they had lent. Borrowers may prefer to lose their property through foreclosure rather than repay loans, and the banks tend to acquire a larger and larger percentage of frozen assets. Bank failures may result in further panic; the tying up of bank deposits in failed banks may reduce still further the supply of funds available to buy goods. Banks become

cautious in extending loans as they are chilled by the cold wind of business pessimism.

Just as expansion was cumulative, so contraction is cumulative; each bit of contraction induces further contraction. The period of contraction is also described as a *depression,* a period of diminished production and consumption. Sometimes the term *recession* is used to designate a mild and brief depression. Enshrouding all is the pessimism which discourages venture and makes people refrain from buying, because they fear still more contraction. Then comes the break in the cloud, the lower turning point.

### The Lower Turning Point

"Prosperity," went the saying during the early 1930's, "is just around the corner." The lower turning point is "the corner," the bottom point in the contraction and the beginning of a new expansion. The depression creates conditions which help to revive business. As prices are low, sooner or later people begin to increase their purchases of goods, particularly those that they have deferred buying during the period of contraction. For this or other reasons, businessmen begin to see profit-making possibilities, and they gradually increase their production. A new cycle is on its way.

### The Importance of Cyclical Fluctuation

The first reason for concern about cyclical fluctuations is that they produce hardships. During contraction or depression, profits decline, unemployment rises, wages drop, standards of living must be lowered. This is a problem for the political statesman as well as for the humanitarian. A hungry people is ever ready to try new forms of political and economic organization. During the 1930's there was a substantial spread of communist and fascist movements.

Instability leads to constant uncertainty and fear. Even in the midst of the overconfidence that is part of the prosperous part of the cycle, there is the realization that the succeeding downswing is bound to come. Cyclical fluctuation is a major hurdle in the attainment of genuine economic security.

In the opinion of some people, cyclical fluctuations reveal a weakness in the structure of our economic system. Instead of working at a level that is continuously high and productive, our economic system has functioned in spurts. At one time we produce at such a high rate that there seems to be a shortage of the factors of production; then we slow down, and our factories, raw materials, and labor force are partly idle. This rhythm of expansion followed by contraction followed by expansion followed by contraction, does not appear to be random or acciden-

tal. The business cycle is believed by many economists to be *self-generating*. This means that each phase of the cycle necessarily creates conditions which set the stage for the next phase. During the expansion phase, the increase of supplies, debts, labor costs, and selling on credit leads to crisis and contraction. During the depression, the reduction of supplies, and the elimination of excess costs, make it possible for business to become profitable again.

## Exercises and Activities

### I Dictionary of Economic Terms

| | | |
|---|---|---|
| business cycle | lower turning point | revival |
| contraction | panic | seasonal fluctuations |
| crisis | prosperity | secular fluctuations |
| cyclical fluctuation | recession | self-generating cycle |
| depression | random fluctuations | upper turning point |
| expansion | recovery | |

### II Questions and Problems

1) (a) List and explain four types of business fluctuation. (b) Which of the four types of fluctuation involves the greatest risk to businessmen? Explain.
2) Examine the chart of business fluctuations on page 625. What evidence does it contain that (a) war periods have been periods of expansion; (b) postwar periods have been periods of contraction; (c) periods of expansion and contraction are not uniform in duration; (d) periods of expansion and contraction are not uniform in degree?
3) Discussion of a business cycle will often use the term "from crest to trough." Explain its meaning and illustrate it from one of the charts in this lesson.
4) Explain and illustrate what is meant by the statement, "expansion and contraction are both cumulative in nature."
5) What is meant by the statement that "a turning point is the result of conditions developing during the previous phase of the cycle"?
6) Examine the chart on page 641 showing the "Economic Factors in Contraction—1929–32." Choose any five statements in this lesson describing what takes place during contraction, and from the chart cite facts which confirm the statements.
7) Many business publications present an "index of business conditions" or a "business barometer." (a) What is the possible value of such an index to businessmen? (b) Why may one factor or a few factors give a clue to changes in all economic activity? (c) What danger is there in using such an index to forecast or predict cyclical fluctuation?

III Things To Do

1) From data in an almanac, the *Statistical Abstract of the United States*, or in the *Monthly Labor Review* (Department of Labor), make a graph showing changes in three important economic factors from month to month from the beginning of the current year. Is there any evidence of a turning point?
2) Read (a) *Our Mysterious Panics*, 1830–1930, by Charles Albert Collman (Morrow). A very entertaining book. The author's idea is that panics are started by activities of financial manipulators. There are many interesting accounts of the events of early crises. (b) *Introduction to Economic Science* by George Soule (Viking, 1949). Chapter 5, "The Ups and Downs of Business." A brief account of facts discovered about the cycle.

# *LESSON* 81 CAUSES OF THE BUSINESS CYCLE

## The Idea of Imbalance

When one part of the human body speeds up or slows down its activities, so that it is not functioning in proper balance with other parts of the body, we experience ill health. So it is, in a sense, with the economic system. When one of the economic factors speeds up, or slows down, at a rate which is out of balance with changes in the other economic factors, there is economic disturbance. *Imbalance* is at the root of the business cycle, and is the basis for each turning point.

The diagram opposite pictures the relationships of some of the major economic factors in a state of balance. If you follow the solid lines in the diagram, you will see that the productive mechanism, at the same time that it produces goods and services, pays out money incomes to those who contribute to production. These money incomes are made up of wages, salaries, profits, interest, rent, royalties, and other such payments. This mechanism works efficiently as long as there is balance between the amount of goods and services produced and the amount of incomes received and used. If, however, production increases more rapidly than demand, production will have to be slowed down. Slowing down production causes a reduction of employment and earnings, a drop in demand; and this leads to still further contraction of production, employment, and incomes. Or, if demand increases more rapidly than production, an inflationary trend may develop, as businessmen try to expand production quickly, and thereby increase the demand for materials, equipment, and labor.

The dotted lines in the diagram show that not all income is spent and

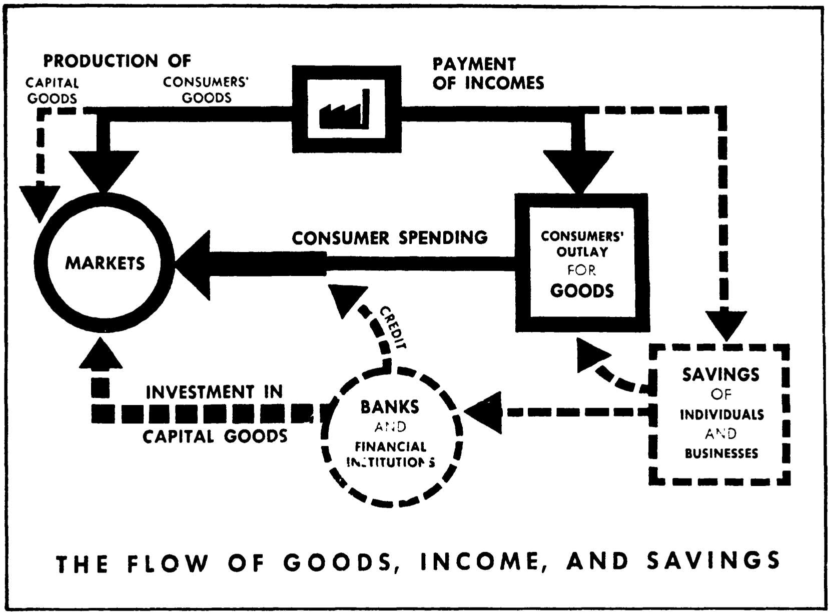



Chart by GRAPHICS INSTITUTE, N. Y.

Starting at the top and following the solid lines in both directions, we note that production results in a flow of goods to markets and, at the same time, a flow of money incomes to those contributing to production. The circuit is completed when consumers spend for consumers' goods. The fact that production may consist of capital goods and that incomes may be saved is shown by following the dotted lines. (The small arrow shows that individuals may dip into savings to increase their spending for consumers' goods.)

that not all production is made up of consumers' goods. Part of the income paid out in the production process is saved; part of the production is made up of capital goods, such as machines and buildings. For the most part these capital goods are purchased with savings; the flow of savings into the purchase of capital goods is called *investment.* The banks act as middlemen in directing the savings of individuals and businesses into investment in capital goods. In addition, the banks, by their power to create credit, are able to increase or decrease the flow of funds going into investment in capital goods, and into spending for consumers' goods. Therefore, in the diagram, the banking system is shown astride the flow of savings and investment.

This flow of production and incomes does not easily stay in balance. Changes in the rates of producing consumers' goods and capital goods, or of spending, saving, and investing, or of credit expansion and contraction, may produce the imbalance which results in a turning point, leading to cumulative expansion or contraction.

To say that the business cycle results from imbalance among the many economic factors does not explain what causes imbalance. Perhaps the outstanding student of business cycles has been Wesley C. Mitchell, who said, "Taken one at a time, most of the theories seem plausible, not to say convincing. Certainly each theory illuminates some angle of the problem. Taken all together the theories . . . figure less as rival explanations of a single phenomenon, than as complementary explanations of closely related phenomena. . . . Thus the diversity of explanations, which at first seems confusing, becomes an aid toward envisaging the complex character of the problem."[1]

### Imbalance in Production Elements

Some economists believe that the cause of the business cycle is *overproduction;* that is, more goods are produced than can be sold at a profit. Various explanations are offered as to why overproduction occurs.

One explanation is that modern production is a long, time-consuming process. Hence, it is easy, even inevitable, for balance between production and consumption to be destroyed. Workers begin to receive incomes before the production process has been completed and the goods put on the market. Hence demand for goods grows faster than the supply of finished goods. This imbalance is increased by the "roundabout" methods characteristic of modern production. Before consumers' goods can be produced, the machines and equipment used in production must be made and raw materials prepared. During this process of making capital goods, incomes are paid out which create a demand for consumers' goods not yet available. Thus demand exceeds supply, prices rise, profits rise, and production is stimulated. There begins an inflationary spiral, which lays the foundation for later contraction.

Another explanation is based on the fact that production ordinarily goes on in anticipation of sales. It is very easy for businessmen to make errors in estimating future volume of sales. Roundabout methods lengthen the lapse of time between production and sales, and increase the difficulty of accurate judgment. Producers are afraid to be conservative in estimating demand, because they may lose opportunities for profit and may allow competitors to get ahead of them. Many kinds of goods are sold to other businessmen, who use the materials and equipment for their own production. Hence, errors in estimating the market tend to be cumulative, from industry to related industry, leading to a wave of overexpansion.

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[1] Wesley C. Mitchell, *Business Cycles, The Problem and Its Setting,* National Bureau of Economic Research, 1927, p. 180.

Overproduction may result also from the lag of costs behind selling prices in the early part of the expansion period. During the previous period of contraction, the costs of doing business have become low—wage rates have been cut, rents have been reduced, and debts paid off. As business conditions improve, businessmen raise prices to more profitable levels. But the rise of wages, rents, and other such costs is slower—it takes time for workers to organize campaigns for higher wages, and rents are kept down for a while by leases. The result is that profits are large, and businessmen are encouraged to expand still more. The increased supply of goods and services increases competition, and eventually businessmen find it harder to maintain profitable prices. Meanwhile, wages, rents, and debt obligations have risen. The margin of profit shrinks, and the upper turning point is reached. During the contraction phase, likewise, prices move faster than costs, but this time downward. Prices must be rapidly adjusted downward to meet competition; but workers resist wage cuts, rents are kept up for a time by leases, and debts are fixed obligations. Because costs go down more slowly than prices, businessmen's losses are heavy. Eventually costs are cut, the opportunity for profit reappears, and the lower turning point is reached.

Some economists place the blame for overproduction mainly on the element of overhead costs. When businessmen expand, they increase their total overhead costs. They sign leases for high-rent locations or buy properties which are heavily taxed. They borrow money and then have large payments to make each year. As total overhead costs rise, more and more business is needed to reduce the overhead cost per unit. The search for more volume of sales leads to cutthroat competition and eventually profits begin to disappear.

### Imbalance in Consumption Elements

Another set of explanations of the business cycle emphasizes the idea of *underconsumption;* that demand does not expand sufficiently to absorb all the goods and services produced.

One possibility is that wages are not increased fast enough to create all the demand which is needed to balance the increase of production. In the early part of the expansion period, the rise of wage rates is slow. Workers are glad to have steady jobs again, and there are still plenty of workers looking for jobs. Not until later, when the surplus of labor is vanishing, do wage standards begin to move upward at a more rapid pace. This lag of wages makes business profitable, but may result in an insufficient market for goods and bring an eventual decline.

Others feel that inequality of distribution of income is the main cause of underconsumption. They point to the fact that the earnings of lower-

income families are almost entirely spent, while the earnings of higher-income families are partly saved. As long as a substantial proportion of the national income goes to high-income families, the amount of spending for goods and services will not be large enough to absorb all that is being produced. In such circumstances, the period of expansion must inevitably come to an end.

Others claim, however, that monopoly is the chief reason for the failure of demand to rise enough to balance supply. In competitive markets, an imbalance between supply and demand is likely to be temporary. If there is a surplus of goods, price is cut, and demand is increased sufficiently to balance supply. In monopolistic industries, however, there is a tendency to solve the problem of surplus by cutting production instead of price. This may mean layoff of workers, reduced purchases of materials, and postponement of expansion of facilities. Such actions quickly affect related industries and begin a wave of contraction.

### Imbalance in Credit and Investment

The starting point of economic imbalance is believed by some economists to be the system of savings, investment, and bank loans.

The ability of banks to issue "deposit currency" makes possible the expansion of production on the basis of credit. As credit outstanding rises, prices and values are pushed up. Each rise in the values of real estate and securities makes possible additional issues of credit, with the real estate and securities used as security. Bank deposits resulting from bank loans begin to reach the limits set by legal reserve requirements, and by the banks' need for safety of its funds. This makes necessary a "tightening" of credit, the refusal of loan renewals, and the liquidation of stocks or other security for loans; and sets off a wave of selling. This may produce a sharp decline in values of securities and other properties, and force still further reduction of credit. This financial retrenchment and liquidation may be the beginning of the contraction phase of the cycle. Later on, when debts have been paid off during the period of contraction, banks have ample reserves, and encourage businessmen to borrow for expansion.

In recent years, much attention has been given to the relationship between investment and the business cycle. The theory has been developed that imbalance is caused by a lack of balance between savings and investment. Savings have a deflationary effect, since they cut down the amount of spending for consumer goods. Investment has an inflationary effect, since it causes the building of more plant and equipment, and starts a spiral of increasing employment, income, and spending. If current saving is greater than investment, the deflationary effect is pre-

dominant, and a period of contraction will follow. If investment is greater than current saving—that is possible, since previously accumulated savings of individuals and corporations can be invested—the inflationary effect prevails, and a period of expansion results. The key to the business cycle, according to this approach, is the amount of investment, especially in the capital-goods industries.



**"But, Pop, if savings exceed investments, a whole downward cycle is set in motion."**

IMBALANCE RESULTING FROM OUTSIDE FACTORS

All the above theories of the business cycle, whether they emphasize production or consumption or investment, imply that the business cycle is self-generating. The alternations of prosperity and depression occur because of developments which take place inevitably in each phase of the cycle. Businessmen, workers, consumers, bankers, speculators, and other groups tend to act in certain ways which cause the imbalance. As has been pointed out in a study made by a business research organization, "the very fact that the economy is free and progressive and prosperous makes it tend to fluctuate—in a word, to be unstable. Why? Because it is free and competitive. Because its behavior is the result of

millions of independent, though not unrelated, decisions. Because it is a money economy and individuals and businesses are free to decide what they will do with their money."[2]

Some economists believe, however, that the real cause of business cycles is to be found in factors outside the economic system. These external factors upset the equilibrium of the business world, and set in motion the self-generating process.

One interesting example of this approach is the "sun-spot theory"; namely, that cyclical fluctuations in business activity are the result of variations in agricultural production caused by fluctuations in the amount of energy reaching the earth from the sun. The fluctuations of solar energy are a physical phenomenon, but the effects are economic. This and other such theories are not widely accepted.

More acceptance is given to the theory that cyclical fluctuations in business are determined by waves of optimism and pessimism, which influence the decisions of businessmen regarding expansion and contraction. Other writers believe that the business cycle originates in the fact that technological inventions tend to come in spurts. In their opinion, business activity expands and contracts with changes in the rate of invention.

The most spectacular of the external factors related to economic activity is war. There have been numerous examples of wartime inflation and postwar deflation.

### Exercises and Activities

I DICTIONARY OF ECONOMIC TERMS

investment overproduction underconsumption

II QUESTIONS AND PROBLEMS

1) Choose any five of the following explanations of the business cycle and explain each in your own words: (a) Certain costs are more rigid than others and encourage overexpansion of production. (b) Incomes are unequally distributed so that spending lags behind production. (c) Savings at one time exceed, and at another are smaller than, investment in capital goods. (d) There are alternating periods of optimism and pessimism in business circles. (e) Monopolists keep prices rigid and adjust production levels. (f) Money supply does not keep pace with expanding production. (g) War causes maladjustments in production and consumption. (h) Technological advances

[2] John Hancock, "Objectivity—The Key to Economic Understanding," *Journal of Educational Sociology*, March, 1950, page 414.

introduce an unsettling factor. (i) Banks tend to overexpand loans for production. (j) Wages tend to lag behind the prices of goods available for purchase. (k) There is a time lag between the payment of incomes by industry and spending. (l) Producers, guessing at future demand, make errors with cumulative effects. (m) Our roundabout method of production requires capital goods production before consumers' good production. (n) Wars and other events create periodic economic disturbance.

2) Using the diagram on page 633, explain (a) the difference between spending and investment, (b) the middleman function of banks.
3) (a) Explain what is meant by "imbalance among the economic factors." (b) Using the diagram on page 633, give an example of a possible imbalance.
4) (a) Explain why there are so many theories of the business cycle. (b) What has been the value of the multiplicity of theories?
5) "Idle dollars profit no man." (a) What is meant by idle dollars? (b) How may the idleness of dollars be responsible for cyclical fluctuations?
6) "Some blame the cycle on 'overproduction,' others blame it on 'underconsumption.' These are only two sides of the same coin." Explain.

III THINGS TO DO

1) With the help of textbooks in American history report on the chief factors underlying one of the following: (a) the Panic of 1837; (b) the Panic of 1873; (c) the Panic of 1893; (d) the depression of 1921–22; (e) the depression of the 1930's.
2) Report on the significance of the work of one of the following economists in formulating economic theory and policy: (a) J. M. Keynes, (b) W. C. Mitchell, (c) Irving Fisher, (d) Joseph Schumpeter. Material may be found in books dealing with the history of economic thought. This is an advanced project.
3) Draw an original cartoon or diagram to illustrate the idea of imbalance.

# *LESSON* 82 COMBATING CONTRACTION: THE NEW DEAL

## THE GREAT PROSPERITY AND THE GREAT DEPRESSION

In his annual message to Congress in December, 1928, President Calvin Coolidge, echoing the opinions of economists and businessmen, said:

No Congress of the United States ever assembled, on surveying the state of the Union, has met with a more pleasing prospect than that which appears at the present time. . . . The country can regard the present with satisfaction and anticipate the future with optimism.

This was less than one year before the sharpest crash in security values the country had ever seen, ushering in the great depression of the early thirties. In June, 1934, a well-known English economist said, "There have been many depressions in modern economic history, but it is safe to say there has never been anything to compare with this. 1929 to 1933 are the years of the Great Depression."[1]

Although hailed as a "new era" of permanent prosperity, the period preceding the crash in 1929 was uneven in its expansion. Farm prices had never recovered from the drop following the post-World War I depression of 1921. Residential and public construction, as well as the automobile and related industries, had boomed; but there were weaknesses in coal mining, railroads, shipbuilding, and textiles. Although foreign trade was large, exports were maintained only by the steady stream of loans to foreign governments. A high tariff policy interfered with imports and reduced the foreign countries' means of payment for our exports. The gold standard, restored after World War I, functioned poorly, and gold reserves tended to accumulate in a few countries. There was widespread security speculation, supported by bank credit. Consumer credit expanded greatly and supported the expanded production of durable consumers' goods such as automobiles, radios, and refrigerators. The turning point was actually reached in June, 1929. Unofficial warnings by some officials and economists were unheeded, because they ran contrary to the optimistic prophecies of many public figures and businessmen. It remained for the market crash in October, 1929, to bring the danger of collapse to public attention.

The period of contraction began in June, 1929, and lasted until May, 1933, a period of nearly four years. But even in the years following the lower turning point of May, 1933, the level of activity was low. One hardly thinks of the years from 1933 to 1937 as marking expansion, although that actually was the case. Unemployment in the millions persisted throughout the 1930's. The depth of the contraction was by far the greatest in our history, as can be seen in the chart on page 625. The chart opposite reveals the extent to which the economic activity of the nation shrank.

Early in 1933, farmers were striking and organizing to prevent foreclosures, banks were in a state of bankruptcy, railroads and utilities were in bad financial condition, and the drop in the value of securities

[1] Lionel Robbins, *The Great Depression,* Macmillan & Co., Ltd., 1934, p. 11.

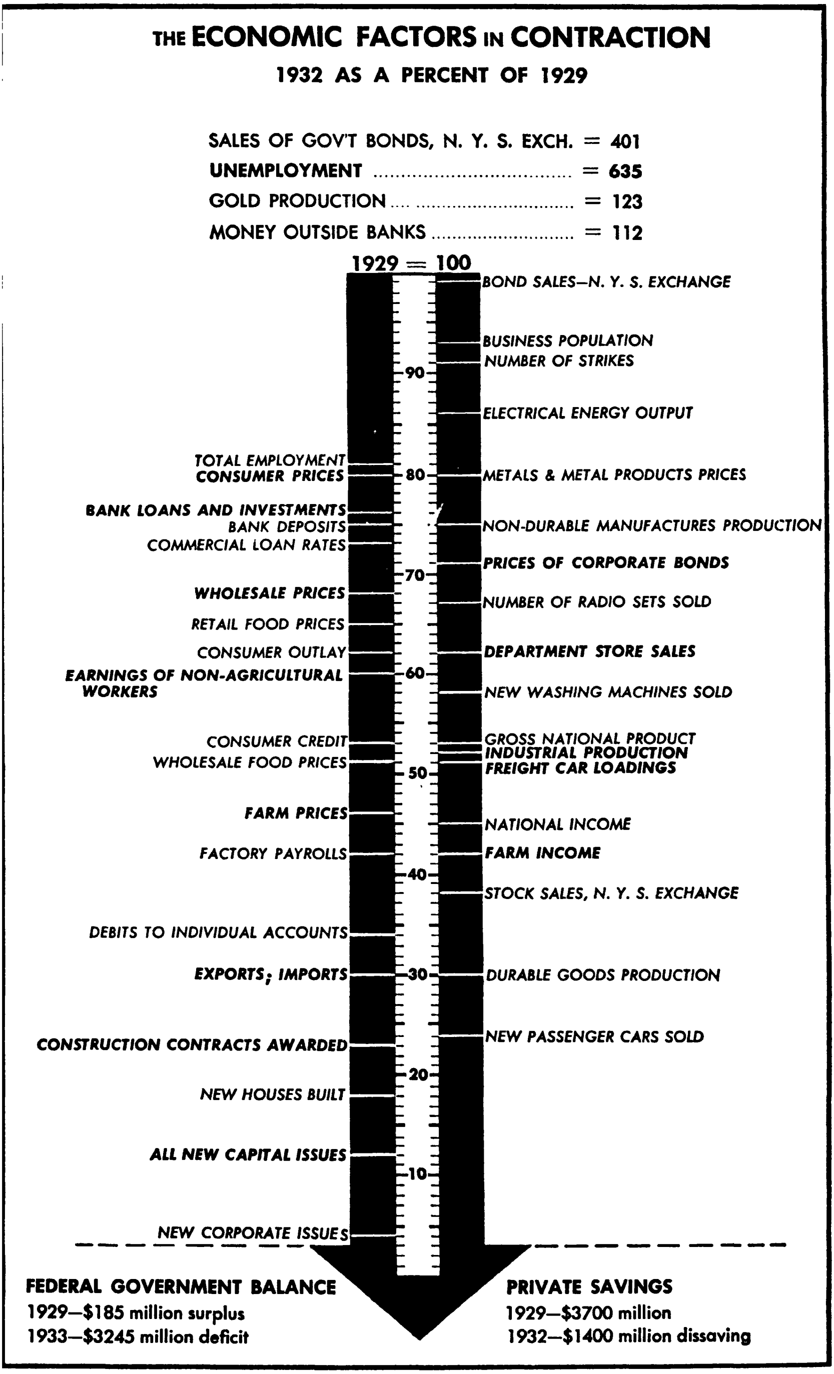



Chart by GRAPHICS INSTITUTE, N. Y.

All factors shown are useful in varying degree as indexes of business conditions.

and other investments left insurance companies and other financial institutions in a dangerous position. Veterans of the first World War were selling apples in the street, and a "bonus army" camped on the threshold of the capital. President Roosevelt's inaugural address summed up the problem and foreshadowed the approach:

> . . . let me assert my firm belief that the only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance. . . . Values have shrunken to fantastic levels; taxes have risen; our ability to pay has fallen; government of all kinds is faced by serious curtailment of income; the means of exchange are frozen in the currents of trade; the withered leaves of industrial enterprise lie on every side; farmers find no market for their produce; the savings of many years in thousands of families are gone. More important, a host of unemployed citizens face the grim problem of existence. . . . We must act, and act quickly. . . .

The series of actions which were immediately begun have gone down in our history as the New Deal.

### The New Deal

The atmosphere of the country during 1933 and early 1934 was that of a people engaged in a crusade to defeat a common enemy, the depression. During these and subsequent years, a bewildering host of alphabetical agencies—AAA, HOLC, NRA, WPA, etc.,—sprang up to administer the far-reaching program of government intervention.

In general, the program of the New Deal aimed in three directions: relief for the chief victims of the contraction, recovery of a high level of business, and reform of our economic institutions. For the most part, these aims were interdependent.

### Measures for Relief

Five major groups in the nation were in need of relief—the workers, the farmers, the banks, property owners (particularly home owners), and industry.

Relief to the worker was given first of all by aid to the unemployed. The Works Progress Administration (WPA) was the end result of a number of experiments in providing jobs for the unemployed. Government projects were established to employ people in building, in the maintenance of public property, in education, and in the entertainment field. This program provided "work relief" in place of "home relief" (or "dole"). The Public Works Administration (PWA) set up plans for the construction of public works projects such as housing, schools, post offices, roads, and dams. Contracts for construction were given to private contractors, who were thereby enabled to increase private employment and purchases. Loans were made to states and local governments,

to enable them to undertake the construction of needed projects. Financial assistance was given to local governments to permit the expansion of their programs of direct relief (money payments) for those who were handicapped or unable to work. For many young people who were idle and without hope, the Civilian Conservation Corps (CCC) provided work in reforestation, fighting forest fires, and other conservational work. The National Youth Administration (NYA) paid students in high schools and colleges for part-time work, and established a system of courses for unemployed youth, to provide training for jobs. The United States Employment Service (USES) was established to provide a public system of employment agencies, to help find and distribute employment.

The methods used to help the unemployed were at the same time a means of encouraging recovery, by increasing the purchasing power of city dwellers, and thus stimulating the demand for goods. On the other hand, many recovery and reform measures contributed to relief as well. The provisions of the National Industrial Recovery Act (NIRA) and the Fair Labor Standards Act for minimum wages and maximum hours, and the guarantee of collective bargaining in the National Labor Relations Act, were measures for raising wages and spreading employment. The Social Security Act introduced a permanent reform by providing for unemployment insurance, old-age pensions, and federally supported public assistance; but it also served to provide relief and increased purchasing power.

The farmers benefited indirectly from many of the steps already mentioned. More directly, they were given relief from the overwhelming burden of their fixed charges by a moratorium, or legislative postponement, of payments on their farm mortgages. Under the Farm Credit Administration (FCA), a broad system of farm credit was organized. In May, 1933, Congress quickly passed the Emergency Farm Relief Act. The first part of this law, generally referred to as the Agricultural Adjustment Act of 1933, provided for government purchases of farm surpluses, and introduced a system of payment of sums to farmers to induce restriction of farm production. Another part of this law was the Thomas Inflation Amendment, giving the government wide powers to inflate the currency, to establish bimetallism, and to devalue the dollar. Thus, the devices aiming at inducing recovery of farm prices, were likewise measures for affording farm relief.

A series of measures were aimed at relieving hard-pressed home owners and financial institutions loaded down with frozen assets. In many states a moratorium was declared on mortgage payments. The Home Owners Loan Corporation (HOLC) was organized by the federal government, to refinance home mortgages at lower rates of interest and for longer periods of time. The Reconstruction Finance Corporation

(RFC) organized in 1932 under the Hoover administration, was continued, and lent many millions of dollars to banks, insurance companies, railroads, municipalities, and other industries, in order to assist the thawing out and gradual conversion of frozen assets. The Banking Acts of 1933 and 1935 provided for a system of federal deposit insurance, under the management of the Federal Deposit Insurance Corporation (FDIC). This helped banks to survive; and deposits of failed banks were at the same time made more quickly available for expenditure.

### Measures for Recovery

An important part of the New Deal philosophy, taken over from the English economist, John Maynard Keynes, is referred to as the policy of compensatory spending; that is, government expenditures for the purpose of increasing production, employment, and incomes. This policy was based on the belief that it was the function of the government, in a period of contraction, to compensate for the low level of individual and business spending and investing, by undertaking a program of government spending and investment. The funds for this government spending were to be obtained primarily by government borrowing, even though it meant that government deficits would develop. It was further believed by supporters of this theory, that the *deficit spending* by the government, by stimulating the production of goods and the payment of additional incomes to workers, would produce a total of private spending and investment greater than the amounts spent by the government. Just as priming a leaky pump can cause it to pump up far more water than the amount poured into it, so a program of government spending was aimed at *priming the pump* of purchasing power.

The recovery measures of the New Deal included attempts to stimulate private industry by granting assistance and removing the blocks to renewed business activity. The Public Works program was an aid to private enterprise. The Federal Housing Administration (FHA) attempted to encourage private building of homes by removing fear of loss. It guaranteed up to 90 percent of mortgage loans made by private banks for home-building purposes. To minimize business losses through cutthroat competition, the NIRA sought to encourage coöperative action without fear of the antitrust acts.

The New Deal also engaged in experimentation with our monetary system. We departed from the gold standard and devalued the dollar, as a means of boosting the price level, hoping it would set off a period of expansion. A program to restore the price of silver and add quantities of silver to our monetary stock was undertaken by the Silver Purchase Act of 1934.

An effort was also made to restore foreign markets. The reciprocal-

trade-agreement program was inaugurated to secure a reduction of the barriers that were choking foreign trade. Loans to foreign nations were granted under the auspices of the Export-Import Bank.

### Measures for Reform

Other sections of this book have described in some detail the aspects of the New Deal which have tended to be permanent reforms. The chief ones are summarized in the table which follows:

| *Law or Agency* | *Purposes* | *Discussed in Lessons* |
|---|---|---|
| National Industrial Recovery Act | To organize industry for self-regulation under codes of fair competition | 40 |
| Agricultural Adjustment Act | To raise the level of prices for farm products by crop restriction and price support | 55 |
| Social Security Act | To set up a system of old-age pensions, unemployment insurance, and public assistance | 60–61 |
| Fair Labor Standards Act | To provide for minimum wages and maximum hours | 59 |
| Federal Housing Administration | To provide guarantees of loans and standards of home building | 12 |
| Securities and Exchange Act and Federal Securities Act | To provide for regulation of securities sales and of stock exchanges | 25 |
| Banking Acts of 1933 and 1935 | To reform banking and to establish federal deposit insurance | 50 |
| Tennessee Valley Authority | To provide for regional planning, conservation, and power production in the Tennessee River Valley | 52 |
| Reciprocal Trade Agreements | To provide by treaty for mutual reduction of tariffs | 75 |
| National Labor Relations Act | To provide guarantees for collective bargaining | 68 |
| Farm Credit Administration | To coördinate and expand agricultural credit | 53 |

The New Deal program asserted, more strongly than ever before in our history, the influence of the federal government. In many respects the New Deal represented a turning away from the ideal of laissez-faire, to the acceptance of government intervention and responsibility for economic welfare. It marked the first attempt by our government to develop a program for preventing, and lessening the effects of, depression.

The accomplishments of the New Deal have been a matter of great controversy. It is not easy to measure the effect of the New Deal on recovery. From 1933 until 1938 there was gradual expansion of economic activity. However, much unemployment still persisted. After 1938 the expansion which developed was largely the result of the European war.

As for the New Deal reform measures, some of them, such as social security and deposit insurance, are now taken for granted, even by most of their opponents of former years. Others, such as the NLRA and parts of the farm program, are still controversial issues, and will probably remain so for many years to come.

### Exercises and Activities

I Dictionary of Economic Terms

| | | |
|---|---|---|
| dole | moratorium | priming the pump |
| deficit spending | New Deal | work relief |

II Questions and Problems

1) List and explain three elements of weakness in the prosperity which prevailed in the period prior to 1929.
2) The New Deal aimed at "relief, recovery, and reform." Explain.
3) State the chief purpose of five important New Deal measures or administrative agencies. Would you describe the aim of each of these as related to recovery, relief, or reform?
4) (a) Explain the principle of compensatory spending. (b) Give an example from the New Deal program which in your opinion is an application of this principle.
5) (a) What is meant by "pump-priming" activity? (b) Give an example of such activity undertaken under New Deal auspices.
6) The New Deal program accepted no single explanation of the business cycle but took measures, sometimes seemingly contradictory, to deal with immediate problems. In illustration of this statement give examples of the following: (a) a program to reduce production of agricultural crops, and a program to provide food for the hungry; (b) a program to restrict the extension of credit, and a program to make credit easier to obtain; (c) a program to eliminate competi-

tion or to reduce it, and a program for industrial coöperation; (d) a program to tax spending power, and a program to increase spending power.

III THINGS TO DO

1) Using this lesson, other parts of this book (consult the index), and a textbook in American history, prepare a more detailed report on any one of the agencies or measures on which you reported in Question 3 above.
2) In any history textbook read the section on the New Deal and report to the class.
3) Consult a history textbook and write a report comparing the New Deal with Theodore Roosevelt's Square Deal or Wilson's New Freedom.

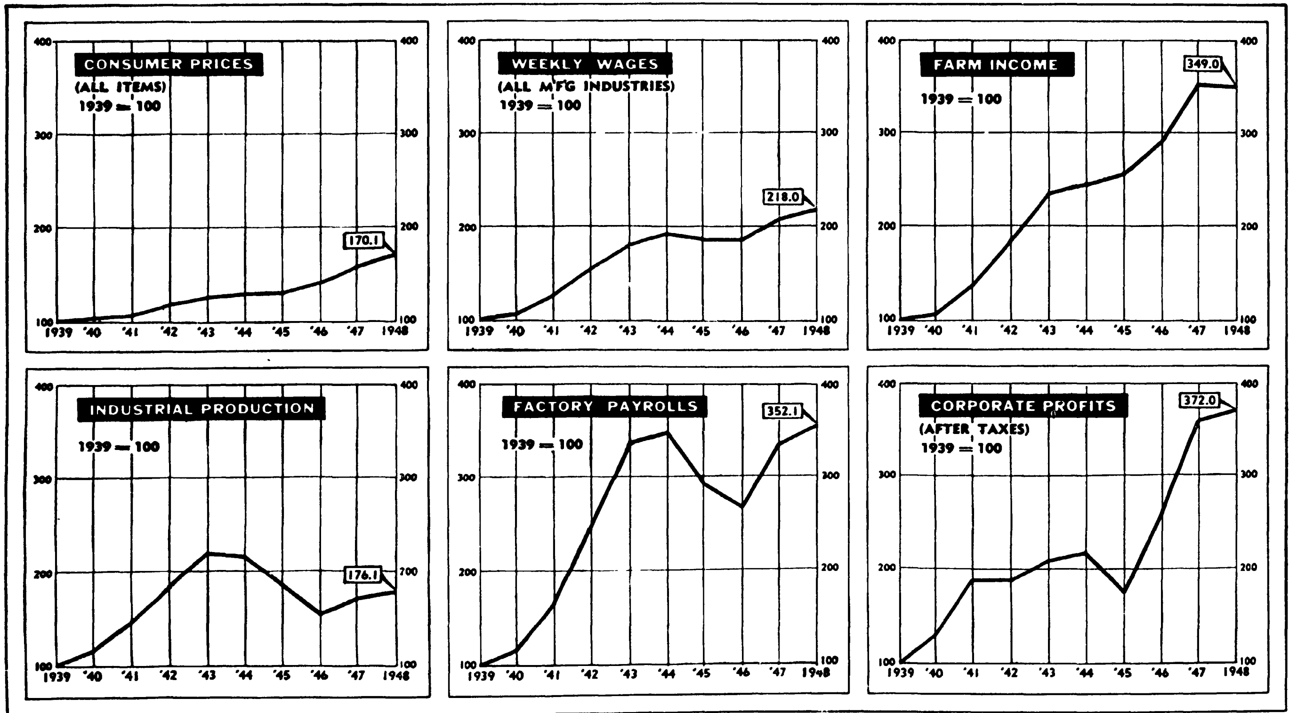
# *LESSON* 83 DIRECTING WARTIME EXPANSION

## THE IMPACT OF WAR

The coming of war at the end of the 1930's reversed the economic trend. During the war, and in the years immediately following, the problem was a scarcity of the factors of production. Factories, men, and materials were inadequate to the sudden great demands for goods and services. The shortage of needed factors of production, accompanied by a tremendous demand, exerted an inflationary effect. Prices rose, and government policy had to shift from encouraging inflation to checking it. Problems of controlling expansion replaced problems of combating contraction.

Even before we entered the war at the end of 1941, the national economy began to feel the effects of the outbreak of war in September, 1939. This is shown in the charts on the next page. Aid to Britain and the Allies on an informal basis, and later under the terms of lend-lease agreements, swelled demand for implements of war, for ships, machinery, and foodstuffs. The United States undertook to make itself the arsenal and the granary for democracy. With our entry into war, we began full-scale conversion to a war economy. Factories were converted from peacetime manufacture of hardware, radios, automobiles, clothing, and other consumers' goods, to the manufacture of shell casings, explosives, tanks, airplanes, battleships, and uniforms. The proportion of national production made up of consumers' goods dropped, and the proportion assigned to military use rose. Yet, so great was the expansion of total

# 1939 TO 1948 — WARTIME AND POSTWAR EXPANSION




THE NEW YORK TIMES

These graphs illustrate some of the most important indexes of business conditions. Note the uneven pace with which these factors changed during this period of general expansion.

production that the output of consumers' goods rose from year to year.

This increase in production placed a heavy burden on the factors of production. Scarcities of key raw materials and capital equipment appeared soon. In addition, the production effort was handicapped by a scarcity of manpower. Millions of men and women were taken into the armed forces. Many civilians were recruited for essential jobs in connection with the war effort.

This shortage of manpower inevitably led to an increase in wage rates and to extra payments for overtime work. Businessmen and farmers also received much higher incomes. The result was a tremendous increase in money available for the purchase of consumer goods. But, because of the need for military goods and heavy equipment, civilian-goods production could not keep pace with the huge increase in incomes. This excess of incomes over the goods available for purchase was referred to as the *inflationary gap.* It was an excess of demand over supply, and caused an upward movement of prices.

The rise in prices was a major problem. In the first place, it increased the cost of the war, and aggravated the problem of raising the huge sums needed by the government. In the second place, rising prices caused demands for increased wages; in the face of labor scarcity, it became necessary to grant such wage increases. As wages and the costs of materials rose, costs of production in industry rose, and necessitated further increases in price. In the third place, the inflationary trend was a constant source of possible disunity. Business profits soared to record heights; and the incomes of farmers and many groups of workers rose faster than the cost of living. On the other hand, many people, including government employees, families living on military allowances, bondholders, and others receiving a fairly fixed income, found the cost of living outstripping their incomes. In the fourth place, the wartime inflation caused worry about a possible postwar deflation. The experiences after World War I were still sharp in people's memories. That war also had seen an inflationary boom, and the postwar period had been one of collapse and economic grief. There was a full realization that, in order to avoid a similar collapse after World War II, rigorous control of the inflationary tendencies would be necessary.

The attack on inflation was made on three fronts: by increasing production, by limiting demand, and by direct control of prices.

### Allocating the Factors and Increasing Production

To control the distribution of scarce materials, and of machinery and equipment needed for production, the War Production Board was established. It established a system of *priorities,* by which materials and equipment were allotted to businessmen and industries in proportion to

importance for the war effort. A national inventory of production facilities was undertaken, and the War Production Board attempted as far as possible to direct new capital and small businessmen into areas where their production would be most needed. Loans were arranged for businessmen, to help them expand industrial facilities. Many new plants were constructed by the government, with government funds, and were operated for the government by private individuals or corporations. The hesitancy of some large firms to increase productive capacity, because they feared postwar surpluses, was overcome by a combination of persuasion, threats to bring antitrust charges, and government financing of new enterprises. New aluminum plants, for example, were constructed in the TVA region. Government insistence managed to break through the obstacle of production-limiting agreements drawn up by international cartels. One of the wartime government agencies, the Board of Economic Warfare, negotiated with other countries for supplies of strategic materials, and coördinated our production efforts with those of our allies.

Steps were taken to direct labor where it was most needed. The War Manpower Commission declared certain jobs essential and limited the movement of civilian workers. The Selective Service deferred from the draft workers in essential industries. The War Labor Board used its power to freeze wages, in order to minimize the migration of workers into higher-wage industries.

Legislation limited the right to strike in war industries. Through the War Labor Board and other mediation agencies of the government, labor disputes were settled with a minimum loss of working time. The chief labor federations of the country pledged that there would be no strikes during the period of the war emergency, and the percent of man-hours lost through strikes was the lowest in our history.

Our total labor force was swelled to new levels. Women filled jobs which had always been held by men. In the schools a "Victory Corps" helped mobilize student labor for volunteer agencies coöperating in the war effort, for plants and offices, and for farm work. A program of retraining was conducted by federal and state governments, by private and public schools, and by industry itself, to teach new workers the new skills needed in the war plants of the nation.

### Limiting Demand

Many steps were taken to limit demand for consumers' goods. One method was a program of education of consumers to buy less, buy wisely, and make things last longer. A constant barrage of literature, advertisements, radio programs, and meetings arranged by the Civilian Defense Volunteer Office (CDVO) drove home the importance of con-

serving food and clothing. The public was urged to buy United States War Bonds, to help finance the war, and to eliminate inflationary spending.

A second method of limiting demand for consumers' goods was to put rigorous controls on personal loans for consumption purposes, and to restrict the use of installment selling. Installment buying was greatly reduced by requiring a larger down payment, and shortening the period for repayment. A third method was to encourage saving to the point where it was almost compulsory. Many firms instituted payroll deductions, whereby a substantial portion of the wage was taken for bond purchases. Actually the main pressure was that of public opinion in a time of active patriotism; but the pressure was effective. A fourth way was the freezing of wages. A fifth was increased taxation. Income-tax rates rose to their highest level, and more individuals paid income taxes than ever before. New excise taxes were levied. Excess profits taxes were levied on industry as a means of raising revenue and as discouragement to raising prices.

The most direct way of limiting demand, however, was through a program of *rationing*. This is a method of controlling the distribution of available goods, so that everyone is given an opportunity to buy a fair share. In ordinary times a person's ration, or share of the goods produced, depends upon the amount of money he has, and the price tag on the goods. Whoever has the greatest amount of money is able to buy the greatest volume of goods. Wartime rationing set out to change this customary pattern, because there were not enough goods to go round. Without rationing, prices might have skyrocketed to the point where only those with a great deal of money would have secured the scarce goods.

The government set for each family a ration of scarce commodities (gasoline, shoes, sugar, butter, meat, and canned goods). Each family registered, and received a ration book with pages of different kinds of stamps. In purchasing rationed goods, the buyer had to give ration stamps as well as money. When he exhausted his stamps he could buy no more rationed goods, regardless of how much money he had.

Rationing was not easy to enforce; in "black markets" goods were sold illegally by dishonest dealers to greedy customers, without ration stamps. Ration stamps were even counterfeited and sold. Nevertheless, the effect of the rationing system had several values. First, it made the sharing of a scarce supply fairer, in proportion to need as well as wealth. Second, it enabled the government to adjust the demand to the supply at any time, by raising or lowering the family ration. It therefore had a third very important result: it made more effective the system of price control which had been introduced.

### Controlling Prices Directly

The government created the Office of Price Administration (OPA) to administer a program of setting *price ceilings,* maximum prices fixed by law. In general, prices were to be the same as those prevailing on March 15, 1942. Exceptions were made to provide relief to businessmen whose prices on that date, for some reason, were too low to be profitable. Ceiling prices were required to be posted, and in the case of many commodities, had to be stated on the price tag. Rents also were fixed. The price-control system extended to all the major elements in the family budget—food, clothing, and housing.

The system was very difficult to administer, because it had so many products and outlets to cover; there were 600,000 retail stores alone to be supervised. It made necessary a great deal of record keeping by businessmen, and a considerable expenditure by the government for supervision. Consumers were not always coöperative, and frequently paid higher than ceiling prices to get scarce goods. Merchants, in some cases, took advantage of this willingness to pay higher prices, and hoarded scarce goods for customers who were not impressed by their patriotic duty to obey the law. It was for this reason, partly, that a system of rationing had to be introduced to help make the price-control system effective. Despite these difficulties, the system of price control was substantially effective in restraining price advances.

In order to make price control effective, the government introduced a program of government subsidies. It was feared that keeping down prices might discourage businessmen from producing. Hence, for a number of products, the government paid the producer a subsidy. The effect of the subsidy was to give the producer a higher price for his product, but the price paid by the consumer remained fixed. The government paid the subsidy from its tax revenues. The subsidy method was used mainly to stimulate the production of minerals and farm products.

### The Problem of Reconversion

At the end of the war many people were impatient with the controls that had been introduced during the war. Ration books were considered a nuisance. Businessmen regarded the reports and regulations as burdensome red tape, and an undue limitation upon their opportunity to make profits. As wartime scarcities of materials and labor declined, the demands for lifting price controls and regulations grew louder on all sides. By the end of 1947 most of the regulations relating to price ceilings, with the exception of rent control, had disappeared.

With the lifting of price controls, before supplies actually had caught up with demand, the cost of living soared to new heights. This was ac-

companied by demands on the part of organized labor for further wage increases to meet the rising cost of living. Once again warnings were sounded that inflation might lead to disastrous deflation. Toward the end of the 1940's there was some decline in prices.

Just as the New Deal program for combating contraction had left a heritage of reforms and new administrative agencies, so the war experience in combating inflation had brought additional forms of government control.

### Exercises and Activities

I Dictionary of Economic Terms

inflationary gap price ceiling priorities

II Questions and Problems

1) Identify each of the following by showing its connection with problems of directing wartime expansion: (a) lend-lease agreement, (b) inflation, (c) War Production Board, (d) Board of Economic Warfare, (e) War Manpower Commission, (f) Selective Service, (g) War Labor Board, (h) no strike pledge, (i) CDVO, (j) United States War bonds, (k) installment buying, (l) ration stamps, (m) black market, (n) OPA, (o) rent control, (p) reconversion, (q) subsidies.
2) List and explain the four major objectives of government control of economic activity during the war.
3) Consult the chart on "Composition of National Product" on page 67. (a) Explain how it reflects the influence of war conditions.
4) Explain the needs which justified the following wartime actions: (a) rationing of gasoline, (b) carrying on scrap-metal campaigns in the schools, (c) selling war bonds, (d) freezing of wages, (e) levying of excess-profits taxes, (f) controlling retail prices.
5) Consult the graph on national income on page 65. What changes took place after 1938? What factors explain the changes?
6) Consult the graph on wholesale and consumer prices on page 367. What changes took place after 1938? What explains these changes? Why?

III Things To Do

1) After consulting an almanac for data, construct a chart entitled "Economic Factors in Expansion—1939–1945" similar to the chart on "Economic Factors in Contraction—1929–1932" on page 641.
2) Read (a) *The Smiths and Their Wartime Budget* (Public Affairs Pamphlet No. 88, 1944), and (b) *Where Can We Get War Workers?* (Public Affairs Pamphlet No. 66, 1942).

3) In a report to the class, compare price control in World War I with price control in World War II.

## LESSON 84 PROBLEMS IN CONTROLLING THE CYCLE

### Types of Control

In a previous lesson, it was pointed out that there have been varied explanations as to which factor is fundamental in causing cyclical change. It is natural, therefore, that there should be similar differences of viewpoint in suggestions for control of the cycle.[1]

There are those who believe that cyclical fluctuations are a natural and unavoidable accompaniment of a free economic system. Equilibrium, or balance, among the economic factors, in their view, results automatically, sooner or later. Changes in supply or demand cause changes in price, which bring supply and demand into a new balance. The balance among our many economic factors is maintained by the force of individual actions in the market for goods, services, and funds without restriction or regulation. If we view the cycle as being a temporary imbalance among the economic factors, which are constantly in the process of reaching balance, then there is no need for introducing measures of artificial control. The imposition of such controls only has the effect of creating further imbalances, and of preventing the automatic reëstablishment of balance among price, supply, and demand. From this viewpoint, control should be limited to removing barriers or restrictions to the free working of economic law. This would mean the elimination of tariff barriers, monopoly, and other restrictions to competition and trade. In periods of contraction, wages and prices should be allowed to fall to their natural levels, in order to stimulate the demand for labor and goods. Relief should be limited to relieving hardship, and government spending for the improvement of business conditions should be frowned upon.

Among those who favor steps to control the cycle, there are differences in approach. Those who believe that cycles result mainly from overproduction and excessive competition, stress measures for regulat-

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[1] Specific proposals are outlined very briefly here and only a few examples are mentioned. The multiplicity of proposals can be seen by reading: Arthur Dahlberg and others, *Recovery Plans*, TNEC Monograph No. 25, Government Printing Office, 1940.

ing production. They suggest measures for a greater degree of planning and coöperation among businessmen, so that it will be possible for business to adjust production to demand, to keep prices and profits stable. This type of thinking, as we have seen, was present in the provision for "codes of fair competition" under the National Industrial Recovery Act, and in such laws as the Miller-Tydings Act, permitting resale price maintenance.

Those who believe, on the other hand, that the primary cause of the business cycle lies in the fluctuations of demand, propose that compensatory spending by the government be used to check the contraction of incomes, spending and investment. The two devices which have been stressed most are *public works* and social security. During the contraction period, the government would set into motion a planned program of construction projects, so as to revive the construction and heavy industries. This would create a spiral of increasing production, employment, incomes, and spending. Once prosperity had been restored, the public works program would be cut down. Similarly, the payments of unemployment benefits, old-age pensions, and public assistance grants would, during the period of depression, keep purchasing power at a level high enough to help business pull itself out of the depression. The guaranteed annual wage has also been suggested as a measure for maintaining a more stable level of wages and purchasing power, thereby preventing serious contraction.

Another approach to the problem of expanding purchasing power has been the proposal to increase government regulation of monopolistic industries. Such regulation, it is argued, would bring about lower prices, raising real income; and would prevent the restriction of output and employment in these industries.

A further device for control of the business cycle has been through plans for the control of money and credit. This approach is based on the theory that the rise and fall of prices, and the accompanying expansion and contraction of business, can be controlled by regulating supply of money and the amount of credit made available to business firms.

There have been proposals for departing completely from a money backed by any metal to a system of paper money, whose supply and value would be controlled by the government in relation to changes in the index of prices. There have been proposals, which to some extent have been put into practice, for more thoroughgoing regulation of bank loans and investments, more careful limitation and control of the issuance of bank credit, and more supervision to check unwarranted speculation. Measures for bank and credit control are being exercised especially through the open-market operations of the Federal Reserve

System, and through the taxing, borrowing and lending policies of the Treasury Department.

MAXIMUM EMPLOYMENT AND MAXIMUM PRODUCTION

The knowledge that there is a business cycle, that expansion has invariably been followed by contraction, is constantly in the foreground of our consciousness. With the ending of hostilities in 1945, the fear that we were destined for a sharp spiral of recession worried all economic groups. Business became wary of heavy inventories; farmers insisted upon the continuation of supports for farm prices; labor argued for measures to maintain a high level of employment.

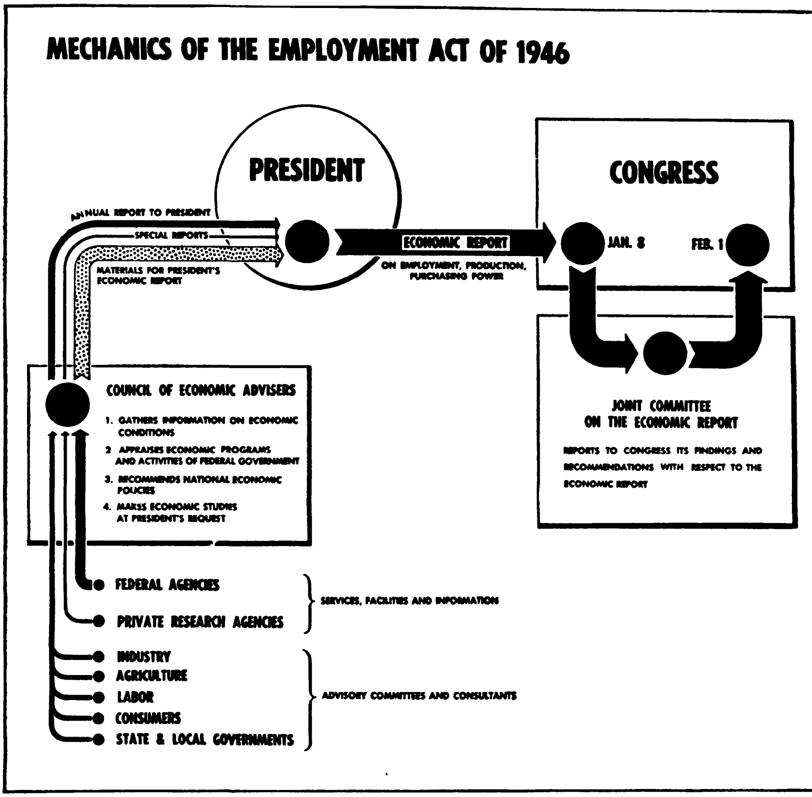
Although nobody favored continuation of the regimentation that war had made necessary, many voices called for government action to prevent recession. To meet this challenge, Congress passed the Employment Act of 1946.

The Act sets maximum employment, the maintenance of purchasing power, and maximum production, as goals for the country's economic system. It requires that the President transmit to Congress, at the beginning of each regular session, an annual "economic report," reviewing the economic state of the nation, and presenting an economic program for the coming year. It provides for the creation of a Council of Economic Advisers, made up of three persons. With the help of a professional staff, they conduct continuing studies of the economic system, as a basis for the economic report. The Council is completely advisory, and has no administrative functions at all. The mechanics of its operations are set forth in the diagram on page 657.

Although the Council is only advisory, its creation was regarded in many quarters as a significant step. It indicated public acceptance of the need for organized and coördinated thinking to develop an economic program for the nation. It was recognition that some plan was necessary, if cyclical changes were to be anticipated in time for concerted corrective measures to be taken.

In the past we have allowed maximum production, which is a desirable thing, to be accompanied by other phenomena which were neither desirable nor necessary. . . . Maximum production requires not only that we provide the best possible equipment for workers' use, but also that we keep our ability to absorb the enlarging flow of produce in step with the rate of capacity enlargement. This in turn depends upon our sagacity in seeking and our promptness in making the appropriate price and income adjustments. For with these adjustments, the demand of our people can keep pace with maximum supply.[2]

[2] Council of Economic Advisers, *Second Annual Report to the President*, December, 1947, p. 12.

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THE CONCEPT OF THE WELFARE STATE

In 1949 President Truman said ". . . we have started out on a program of trying to plan our economic future. . . ."[3] In making this statement, the President was reflecting the belief of many people that the system of private enterprise cannot survive without some control and planning, which would make it possible to meet the problems of the business cycle. This opinion has been thus summarized by Supreme Court Justice William O. Douglas:[4]

The problem of the business cycle must be tackled. Violent swings in it are not as certain as death and taxes. Nor are they as inexorable as the laws of nature. They are man-made and therefore can be controlled by man. . . . The sound direction . . . is the creation of a human welfare state—the great political invention of the twentieth century. . . . We democrats have gone

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[3] See *The New York Times*, Feb. 2, 1949.
[4] See *The New York Times*, Feb. 20, 1949.

far in our outstripping all our competitors in technical skills of industry. We must now outstrip them in the development of the art of social collaboration.

There has recently been much discussion of the idea of a *welfare state*, a government which assumes the responsibility for protecting and improving the economic welfare of its citizens. This idea is in contradiction to the idea that the community makes the most progress by leaving it to every individual to protect and improve his own economic welfare.

The program of a welfare state consists of the following objectives: (1) to provide security in cases of unemployment, old age, sickness, accidents, death of the breadwinner, and physical handicaps; (2) to maintain maximum effective employment of labor, capital, and natural resources; (3) to plan for continuous expansion of production and consumption, in order to raise the standard of living; (4) to increase economic stability by leveling the periods of expansion and contraction.

Does a welfare state mean such a degree of economic planning as would tend to destroy freedom of enterprise? That is a difficult question to answer, because of lack of experience. The concept of the welfare state has been part of the socialistic program of the British Labor Party. The same concept has been advanced in this country by individuals and groups who are convinced that such a program can be achieved within a capitalistic system. This belief, that a welfare state and a capitalistic system can go together, is shown in the statement by the Council of Economic Advisers that "The Council's interest in the orderly evaluation and systematic reconciliation of public policies should not be misconstrued as any leaning toward 'blueprinting the economy' or 'central planning.' "[5]

### Looking Ahead

There is ample evidence that the American people are overwhelmingly opposed to far-reaching public planning of their economic activities, except in the grave emergency of war. Yet, from the early days of the nation, there has been a growing degree of government control over the economic system.

Since the early days of the American nation, tariffs have been used as a means of protecting manufacturing industries against foreign competition. During the nineteenth century, the federal and state governments gave land and financial aid to business firms, to promote the building of canals, highways, and railroads. An extensive system of reg-

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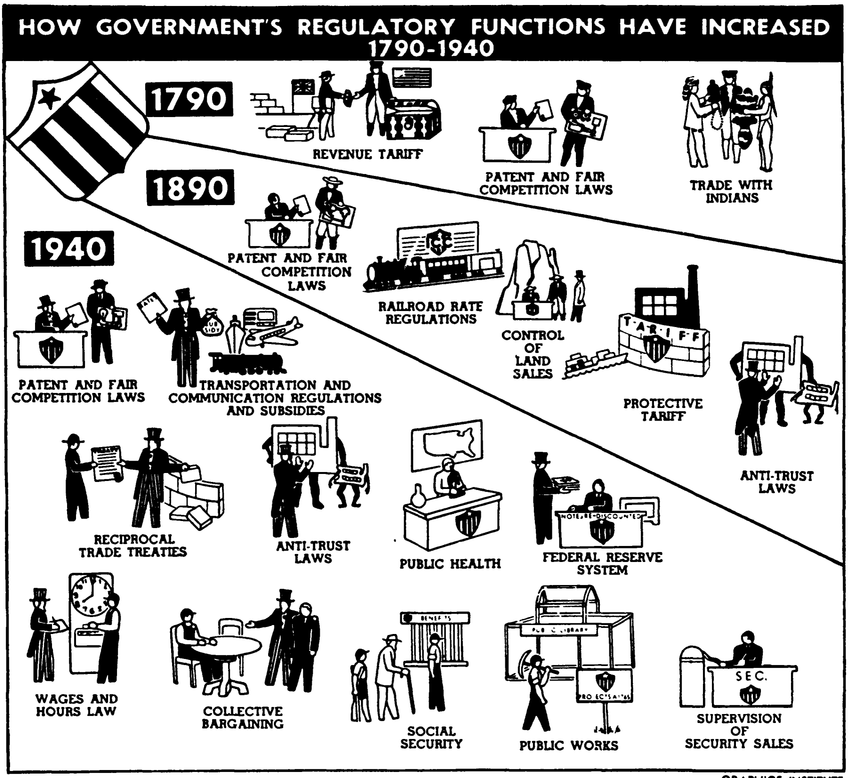
[5] *Business and Government*, 4th annual report, Council of Economic Advisers, December, 1949, p. 23.

ulation of public utilities by federal, state, and local governments has been developed. Many activities of the business world are checked and regulated through such federal agencies as the Securities and Exchange Commission, Federal Trade Commission, Food and Drug Administration, and numerous similar agencies in state and local governments. The foreign trade carried on by our businessmen is considerably influenced by the Reciprocal Tariff Act, the European Recovery Program, and our



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participation in the International Bank, the International Monetary Fund, and the International Trade Organization. Through the Federal Reserve System the government has tried to control the use of credit and thereby to check inflation and deflation. The Tennessee Valley Authority established a precedent for regional planning. Through the farm program the government has undertaken the task of stabilizing the income of the farmers. At the same time it has attempted, by means of minimum-wage laws, unemployment insurance, and old-age pensions, to lessen the fluctuations of workers' incomes. By creating the Council of Economic Advisers, the government hopes to find a way of curbing the upward and downward swings of the business cycle.

More and more we have become accustomed to government policies which place limitations upon, or in other ways influence, the economic actions of individuals and groups. Yet the American people have not given up the principle of freedom of enterprise. They have regarded all these steps toward public control necessary for solving the problems arising out of our system of private enterprise; rather than as steps toward a different kind of economic system. But there is much difference of opinion among the people of this nation as to how far these controls can be carried without destroying the system of private enterprise.

As we enter the second half of the twentieth century, we are concerned with two goals: (1) increasing our economic security, and (2) preserving our personal liberty. Can these two goals be realized together? The believers in the welfare state say, "Yes!" Others say, "No!" although in many cases they favor specific features of the welfare state, such as social insurance. The difference in viewpoint is illustrated in a campaign slogan used in the 1950's, "Liberty or socialism!" and the statement, some years ago, of the late President Roosevelt:

> History proves that dictatorships do not grow out of strong and successful governments, but out of weak and helpless ones. If by democratic methods people get a government strong enough to protect them from fear and starvation, then democracy succeeds; but if they do not, they grow impatient. Therefore, the only sure bulwark of continuous liberty is a government strong enough to protect the interests of the people, and a people strong enough and well enough informed to maintain its sovereign control over its government.

## Exercises and Activities

### I Dictionary of Economic Terms

welfare state | public works

### II Questions and Problems

1) Identify each of the following by showing its connection with proposals for controlling cyclical fluctuation: (a) Council of Economic Advisers, (b) equilibrium, (c) NIRA, (d) guaranteed annual wage, (e) compensatory spending, (f) control of monopolies, (g) Federal Reserve System, (h) National Bureau of Economic Research.
2) Explain the aims and mechanism of the Employment Act of 1946.
3) Give and explain one example under each of the following: (a) Proposals for controlling production, (b) proposals for controlling purchasing power, (c) proposals for controlling money, (d) proposals for controlling credit.
4) Explain how the following problems arise in attempts to control the

business cycle: (a) inadequate statistical data, (b) rivalry of political parties, (c) the threat to political freedom, (d) pressure from economic groups.

5) Some writers have said that depressions are a necessary part of a dynamic economy in growth and that measures to control cycles can only create more problems than they solve. Do you agree? Discuss.
6) (a) List three ways in which the government has promoted free enterprise during the 19th and 20th centuries. (b) List three ways in which the government has limited free enterprise during the 19th and 20th centuries. (c) What evidence is there that the American people are generally opposed to economic planning? What evidence may there be to the contrary?
7) "The so-called system of laissez-faire, or noninterference, was in itself a plan or method, by which . . . economic progress and human advancement could best be promoted." (*Controlling Factors in Economic Development* by Harold G. Moulton, Brookings Institution, 1949, p. 153.) (a) Show how the free-enterprise system has involved planning. (b) What are the advantages of individualistic planning over public planning? (c) What weaknesses in individualistic planning have led to a demand for public planning?
8) "It's not the capitalism of the past. It's not socialism. It's a coöperative, state-aided capitalism dedicated to human welfare." (*New Republic,* February 14, 1949, in discussing the meaning of the Employment Act of 1946.) Explain each of the three sentences; in each case show why you agree or disagree.
9) "Economic planning, public ownership, government control, welfare state—these are only polite terms for the same thing—socialism—and inevitably communism." Do you agree? State your reasons.

## III Things To Do

1) Obtain a copy of a report of the Council of Economic Advisers. Report on the recommendations that are relevant to the control of business cycles.
2) Read and report on the proposals for control of the cycle, in *Recovery Plans* by Arthur Dahlberg (TNEC Monograph No. 25, U.S. Government Printing Office, 1940).
3) Compare the progress of the welfare-state programs in Great Britain and the United States.
4) Read and report on *The Valley is Paying Off* (Tennessee Valley Authority, 1949), a report on the TVA as an experiment in regional economic planning.

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